S. HRG. 98-106

# INDEMNIFICATION OF GOVERNMENT CONTRACTORS

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## HEARING

BEFORE THE

## SUBCOMMITTEE ON ADMINISTRATIVE PRACTICE AND PROCEDURE

OF THE

## COMMITTEE ON THE JUDICIARY
## UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

OVERSIGHT HEARING ON INDEMNIFICATION
OF GOVERNMENT CONTRACTORS

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# INDEMNIFICATION OF GOVERNMENT CONTRACTORS

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FRIDAY, MARCH 18, 1983

U.S. Senate,
Subcommittee on Administrative
Practice and Procedure,
Committee on the Judiciary,
*Washington, D.C.*

The subcommittee convened, pursuant to notice, at 10:15 a.m., in room SD-226, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the subcommittee) presiding.

Staff present: John Maxwell, chief counsel and staff director; Lynda Nersesian, counsel; Susan Shirk, chief clerk; and Arthur Briskman, minority counsel, Subcommittee on Administrative Practice and Procedure.

## OPENING STATEMENT OF SENATOR CHARLES E. GRASSLEY

Senator Grassley. This subcommittee oversight hearing will consider the allocation of third-party liability between the U.S. Government and its contractors.

For those of you who attended last year's oversight hearings, you may have noticed that the subcommittee has a new title. We have incorporated the jurisdiction of the Subcommittee on Regulatory Reform into the Subcommittee on Agency Administration and have come up with a new name—however, it is a name that was similarly used in the late 1970's by the Subcommittee on Administrative Practice and Procedure.

Last year, on two separate occasions, this subcommittee heard from a number of distinguished witnesses. The record of those two hearings is printed and is currently available for anybody who wants it in my subcommittee office.[1]

The perspectives on the current liability situation confronting the Government contractor basically break down into two interests. The Department of Justice is on record as opposing any legislation to expand the liability of the U.S. Government. The Department has emphasized that the Government should not be liable where it has already compensated its employees. The Department also underscored the cost burden that would be imposed on the Government and the taxpayers if forced to pay contributions to contractors. The Department also testified that Government contracts are still actively pursued. Assistant Attorney General McGrath stated last year:

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[1] The Subcommittee on Administrative Practice and Procedure, formerly the Subcommittee on Agency Administration, held previous hearings on oversight of indemnification of Government contractors September 30 and December 2, 1982. They can be obtained from the subcommittee by ordering volume J-97-145.

> The fact that considerable visible effort goes into the competitive battle to secure an edge in receiving Government business speaks eloquently against the argument that the expansion of indemnification is necessary.

From a different perspective, most of the contractor witnesses noted two major problems regarding third-party liability. First, court decisions in recent years have established that injuries arising from Government contract product defects are not compensable by contribution or indemnity in a third-party action against the Government. Nevertheless, a contractor may be held liable for full payment of liability to Government employees, even though the Government was partially or wholly at fault in causing the harm to the employees. Second, a Government contractor may very well face risks that far exceed the typical risks accompanying a commercial contract. Military research and development programs often require a contractor to push well beyond the state of the art—into massive risks that cannot be calculated in advance.

Since our December 2 hearing, two changes in the indemnification area have transpired. First, the National Aeronautics and Space Administration has issued authority to indemnify certain NASA contractors and subcontractors involved in space activities. In its notice of intent, NASA reported that:

> Recent premium quotes for liability insurance verge on the unreasonable to the extent that NASA's funds are used to reimburse contractors and their subcontractors for the exorbitant costs of liability insurance for space activities, it is to the detriment of NASA's mission in space.

NASA found that it would be unable to attract the essential participation of private contractors in space activities without the use of this authority.

The second event that has occurred since the December 2 hearinq is the Supreme Court's decision in the *Lockheed* case. *Lockheed* held that the exclusive liability provision of the Federal Employees' Compensation Act does not directly bar a third-party indemnity action against the United States. I hope to have some of our witnesses comment on the implications of this case today.

At the time a contract is awarded, there is no way of knowing when or if the contractor will become liable for damages caused by the contract item, or how large a loss he will sustain.

I believe I can safely say that the extent to which Government contractors have difficulty obtaining adequate insurance coverage for risks which typically accompany contracts could mean the difference between bidding and not bidding for a major Government program. Given the need for maximum industry participation in the bidding process in order that the cost-safety and cost-conscientious contractors will actively participate, it is time that we at least consider solutions to present Government fault schemes as well as catastrophic loss potential. That is the purpose of these oversight hearings.

Today, our distinguished panel of witnesses includes Mr. Neil Hosenball, Mr. Robert Wojtal, Mr. John Geaghan, Mr. David Bowman, and Mr. Fred Souk.

We have a new ranking minority member on the subcommittee, taking over for Senator Metzenbaum, who served in that capacity last Congress, and that is Senator Howell Heflin, from Alabama, and without objection, his statement, which I will not take time to read, will be printed in the record, and I would like to have the panel members and other committee members look at it, as well. Also, I would like to submit for the record a statement from the Office of Management and Budget and a letter from the American Bar Association.

[The following was received for the record:]

## PREPARED STATEMENT OF SENATOR HOWELL HEFLIN

Today, the subcommittee will conduct an oversight hearing on Government Contractors Liability. I would like to thank Chairman Grassley for his interest in this matter.

As we all know, under the sovereign immunity doctrine, the Government can only be sued where it has given its consent to be sued. This doctrine virtually guarantees that the Government contractor and involved subcontractors of all tiers will be the primary defendant in any product liability litigation involving a product delivered to the Government. While the contractor in the private sector is also liable for any defects in his goods, the Government contractor is in a different and unique position. The Government contactor is typically obligated to perform its contract in compliance with a myriad of specifications. In many cases, the Government contractor furnishes a custom type, complex product, the use of which the product is put by its very nature creates risks.

This was well illustrated in the 1977 Supreme Court decision involving Stencel Aero Corporation. Stencel was sued for damages resulting from a design defect in a device it had built for the Government according to government contract specifications. Stencel had even suggested a design change. Stencel argued that the government should share some liability. The Supreme Court ruled that the Federal Government could not be sued in such cases. Stencel was forced to bear the entire cost.

While it can be argued that the Government should share this liability, it may also be argued that the Government as a nonprofit making organization operating on a limited resource of taxpayer's money, cannot afford to indemnify these contractors.

In this hearing, we will examine the unique role of the Government contractor and the contractor's relationship with the Government. We will also consider the many factors involved in this relationship and examine the possibility of a reasonable balancing and allocation of the risks and liabilities between the Government and the Government's contractors who supply goods and services to the Government.

I certainly look forward to receiving the testimony of these distinguished witnesses and working with my colleagues in studying this complex matter.

Thank you, Mr. Chairman.

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## STATEMENT OF THE OFFICE OF FEDERAL PROCUREMENT POLICY CONCERNING PRODUCT LIABILITY PROBLEMS ENCOUNTERED BY GOVERNMENT CONTRACTORS

The Office of Federal Procurement Policy (OFPP) is aware of the concerns of Government contractors in the area of product liability and the potential liabilities to which they have been or may be exposed in providing goods and services for use by the Government. These concerns of Government contractors, however, must be considered by OFPP in light of two of its major statutory objectives. Namely, to promote economy, efficiency, and effectiveness in the procurement of property and services for the executive branch of the Federal Government, and to promote fair dealing and equitable relations among the parties in Government contracting.[1]

OFPP's activities concerning product liability have centered around the issue of indemnification of Government contractors. The Commission on Government Procurement (COGP) considered the issue of liability of Government contractors and, in its 1972 Report to the Congress, recommended legislation to provide Government indemnification of contractors above the limit of available insurance for liability for damage arising from a catastrophic accident in connection with a Government program.[2] The recommendation was evaluated by OFPP during the mid-70's, culminating in a March 9, 1977, proposal to recommend legislation to the Congress to provide indemnification authority for all contracting agencies along the lines recommended by the Commission. The proposal, however, was not submitted to the Congress because further study was considered to be needed.

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[1] 41 U.S.C. 401 (9) and (12).

More recently, OFPP and NASA co-sponsored an interagency task force on indemnification. In response to a recommendation by the House Committee on Science and Technology, this task force reevaluated the executive branch position concerning the COGP recommendation. The committee had recommended that NASA should consider providing third-party liability indemnification to space systems contractors whenever feasible and in the best interest of the United States Government.[3]

The task group was made up of representatives of the Offices of General Counsel of DOD, DOE, DOJ, NASA, NRC, FEMA, NSF, GAO and Commerce, along with OFPP representatives. The task group consulted 35 agencies in the executive branch and representatives of the private sector in arriving at its conclusions and recommendations.

Several agencies reported contracting situations under which they had agreed, without specific authority, to indemnify contractors engaged in certain activities. Those activities included contract airline evaluation flights from Southeast Asia (AID), acquisition of utility services for Federal installations (GSA), and testing of devices and compounds using human subjects (HHS). In addition, there were a few instances reported where contractors refused to compete for contracts without being indemnified. Representatives of the private sector reported their experiences with increased liability insurance premiums; the infinite nature of their tort liability exposure under many long-term Government programs (including space activities); the effect of the doctrine of strict liability which is being applied in varying degrees in State courts; and what they perceived as the unfairness of the Government's immunity from suit in certain product liability situations.

The task group concluded that the needs of the executive branch agencies could be met by a limited expansion of the indemnification authority provided for under Public Law 85-804 as implemented by Executive Order No. 10789, as amended. Under these provisions, certain executive branch agencies may indemnify a contractor for damages above the level of reasonably available insurance coverage when that contractor is engaged in a contractual activity which is unusually hazardous or nuclear in nature in furtherance of the national defense. The revision proposed by the task group would have expanded the number of agencies which could utilize the authority and would include space activities as a covered category of activity. This recommendation is contained in the task group report of January 28, 1982. The report represented the personal views of the individual task group members and not necessarily those of their respective agencies. The task group member from the justice deparment dissented.

The administration is evaluating the need for additional indemnification authority. Among the concerns being considered in the evaluation will be those which have already been raised: (1) by the Justice Department in regard to any increased exposure of the Public Treasury to third party tort liability claims; (2) by the Department of Defense, that there is a need for limited indemnification authority separate from that authority under Public Law 85-804; and (3) by NASA in regard to the excessive cost of liability insurance premiums which space system contractors are experiencing.

Federal Government programs require qualified contractors to provide the products and services necessary to ensure success. Moreover, the Government must be able to obtain such products and services using efficient and cost effective contracting procedures. OFPP is opposed to sweeping changes in the current statutory and administrative provisions which permit indemnification of contractors engaged in selected areas of government programs. We suggest that a great deal of further analysis is necessary to determine the impact of any provision to expand Government indemnification authority. That analysis should include the effect upon the budget and appropriation process, liability insurance programs, and competition for Government contracts. We believe that a careful review of these issues will achieve a proper balance between concerns of Government contractors and the public interest for efficient accomplishment of Government programs.

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[2] "Report of the Commission on Government Procurement," Vol. 4, p. 101.

[3] Report No. H.R. 97-32, May 18, 1981, p. 24.

**American Bar Association,**
*Washington, D.C., April 1, 1983.*

Hon. **Charles E. Grassley,**
*Chairman, Subcommittee on Administrative Practice and Procedure, Committee on the Judiciary, U.S. Senate, Washington, D.C.*

**Dear Mr. Chairman:** It is our understanding that your Subcommittee recently held oversight hearings to explore the need for legislation in the area of government contractor indemnification. We wish to express our support for such legislation and request that you include this letter in the hearing record.

In February, 1983, the American Bar Association approved a resolution supporting the enactment of legislation allocating product liability risks between the federal government and its contractors, and providing, in certain instances, indemnity against those risks. This resolution recognizes that there is a uniquely federal interest in the treatment of compensation and liability for injury or damage arising out of an activity conducted pursuant to a federal government contract. It also recognizes that the present contractor in an adverse manner.

Illustrative of the problem is the dilemma confronting the contractor as recognized by the court in the case of Henry V. Textron, Inc., 577 F. 2d 1163 (4th Cir. 1978), *cert. denied,* 439 U.S. 1047 (1978). There the court affirmed the lower court's denial of Bell Helicopter's attempt to implead the federal government in a case arising out of the deaths of two Virginia National Guard pilots in a helicopter crash. Acknowledging that the U.S. Government, the State of Virginia, and the Virginia National Guard were more responsible than Bell for the crash, the court said:

"Bell Textron is placed in a very difficult position by the expanding doctrines of product liability and the relatively inflexible doctrine of sovereign immunity . . . but, unfortunately for it, the law is clearly against it." (p. 1164).

The Agent Orange litigation—in the early stages of what promises to be a tortuous path—suggests both the potential magnitude of the contractors' exposure and the almost random nature of the result from the claimant's standpoint. In ruling on the chemical company defendants' motion to dismiss, the District Court held inter alia that they would be entitled to a judgment dismissing all claims if they established that the government established the specifications, that the product met the specifications in all material respects and that the government knew as much or more than the company about the hazards of use of Agent Orange. *In re Agent Orange Product Liability Litigation,* 534 F. Supp. 1046 (E.D.N.Y. 1982). From the claimants' standpoint, it seems singularly unsatisfactory to make recovery dependent on the relative knowledge of the hazard as between the manufacturer and the government, assuming that even if the government had equal or superior knowledge it will be insulated from liability under the Federal Tort Claims Act.

These two examples point to the need for remedial federal legislation in this area. We hope that your Subcommittee concurs and drafts legislation addressing this issue.

Thank you for the opportunity to present the views of the American Bar Association.

Sincerely,

Robert D. Evans.

Senator **Grassley.** Our first witness is Mr. Neil Hosenball, and he has Mr. Wojtal with him. Mr. Hosenball is general counsel for NASA. He was appointed NASA general counsel in 1975, after serving as deputy counsel since 1967. Mr. Hosenball, we are pleased that you are with us here today. We are especially interested in reviewing the factors that prompted NASA administrators to authorize NASA contracting officers to indemnify certain NASA contractors and subcontractors involved with the agency's space activities.

I would like to have you do the usual, of incorporating your statement in the record as it is written and summarizing to the best extent you can, so that the committee hearing can move along.

I thank you very much, and please, proceed as you like.

## STATEMENTS OF S. NEIL HOSENBALL, GENERAL COUNSEL, AND ROBERT J. WOJTAL, CHAIRMAN, INTERAGENCY TASK FORCE ON INDEMNIFICATION, AND ATTORNEY-ADVISOR, NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

Mr. **Hosenball.** Thank you, Mr. Chairman. I will do as you requested and summarize my statement.

As you indicated, I understood that you did wish me to give you the circumstances and facts that caused us to proceed with our Memorandum Decision on indemnification, and I will do so.

Basically, Mr. Chairman, what had occurred, to move us a little faster, perhaps, than we wished, was that it was brought to our attention that in negotiating renewals of their existing coverage—either the product's liability coverage our contractors carried, or in some cases, they carried general liability coverage, which covered the shuttle—the premiums were substantially, very substantially, increased. For example, in one contractor's case, where he had previously been paying a premium of approximately $230,000, it now became apparent that he would be paying a premium for this year, or during the then period, of approximately $2.9 million, well over a tenfold increase. In addition, since the shuttle was singled out as causing this increase, the charge for that premium was submitted to us as a direct cost to the shuttle contract. Normally, as you may be aware, insurance is a G&A expense, and spread over the business of the particular contractor. Subsequent conversations with other contractors indicated they were facing a similar situation, in some cases, not as large an increase, but very, very substantial and significant.

The other reason that we proceeded the way we did, we found a situation where the Air Force was procuring a stage for us, as well as themselves. One of the subcontractors performing on that procurement had received indemnification from the Air Force on the Air Force work, but had excluded certain work to be performed from the NASA portion of that procurement because he did not have indemnification. These two factors caused us to discuss it with the administrator further, as we had been doing all along the line. We examined again the FAA Memorandum Decision which had been issued earlier. We found that the circumstances that we faced were very similar, if not the same, as they faced; therefore, we decided to proceed on the same basis that there was a catastrophic potential and would then indemnify our contractors in a limited indemnification, but covering only the Space Transportation System. It does not cover all of NASA's space activities.

We are proceeding down that path and have been meeting with contractors who have requested coverage. Hopefully, we should have coverage in place probably before the next launch, which is now scheduled for early April.

I think, sir, that that probably summarizes pretty much what I say in the statement and also gives you the background that lead to our proceedinq the way we did.

Senator **Grassley.** Mr. Hosenball, did you plan for Mr. Wojtal to have any opening statement?

Mr. **Hosenball.** If I can, Mr. Wojtal, our counsel for Launch Services Agreement, is familiar with how we proceeded on the——

Senator **Grassley**. Why don't I ask you questions, then, and we will go to Mr. Wojtal.

Mr. **Hosenball**. Either way.

Senator **Grassley**. It is my understanding that under the new policy, it is the responsibility of the shuttle contractors and subcontractors to request indemnification coverage from NASA; is that correct?

Mr. **Hosenball**. That is right, sir.

Senator **Grassley**. How many contractors or subcontractors have requested indemnification since you announced your policy?

Mr. **Hosenball**. Mr. Wojtal can correct me, but I believe there have been 10 that have come in.

Mr. **Wojtal**. Approximately that number.

Mr. **Hosenball**. Approximately 10.

Senator **Grassley**. Why isn't it automatic, and why do they have to request?

Mr. **Hosenball**. In some cases, the contractors may feel they have adequate coverage, or their potential liability is so remote that they do not feel that they have to. You must remember that we have literally hundreds of subcontractors. In many cases, we cannot even identify all of them. So we have published the Memorandum Decision. It has gone out by way of procurement notice. We would assume that contractors who wish the protection and feel that they need it one way or another would come in to request it. Then we can process the request in the normal way. There is a great deal of information that does have to be submitted, and it does take some processing.

Senator **Grassley**. Has your indemnification policy been restricted at all by OMP or any other Government agency?

Mr. **Hosenball**. We have had discussions both with OMB and the Department of Justice. In our most recent discussions, I think the OMB recognizes that we do have a unique situation, and we have been authorized to proceed in this limited way, yes.

Senator **Grassley**. Will the policy be implemented for past and current contractors, as well as future contracts?

Mr. **Hosenball**. Unless they are a current contractor, there is no way we can put it into any existing ongoing agreement, so they would have to be at least a current contractor.

In general, our current contractors will continue on the STS program for quite some time.

Senator **Grassley**. By "past contractor," I would include in that people who I suppose you could still call a current contractor, but the contract may have been negotiated years ago, but ongoing.

Mr. **Hosenball**. It is being incorporated into those contracts, yes.

Senator **Grassley**. In NASA's Memorandum Decision in paragraph 2, it is stated that:

> The initiation of space transportation system operations has dictated a reexamination of the present availability of adequate insurance at reasonable premiums to manufacturers and operators of the system." Further down in paragraph 2, it states that:
>
> In the event of a malfunction, the potential liability could be in excess of the insurance coverage NASA contractors could reasonably be expected to acquire.

What is NASA's definition of "reasonable premium" or "one that contractors could reasonably be expected to acquire"—and those are your words.

Mr. **Hosenball**. In the process of the submission of requests by contractors, we have requested each of them to provide their insurance program to us and also to furnish us with the premiums that were paid in the prior renewal term. And, yes, it calls for a judgment. The example that I gave you earlier of one contractor who has indicated that his insurance in the prior renewal period was $234,000 related to the space shuttle, is now being increased to $3 million. We have to make a judgment as to whether there is a substantial risk of exposure, both from a legal as well as a technical standpoint. The contractors are concerned about a catastrophic situation, as well as from the point of view of potential lawsuits. Whether there would be recovery or not remains to be seen. For example, if a shuttle with three commercial payloads were onboard, happened to land in a populated area, you would not only lose the three payloads but there would be damage on the ground, as well. If you just look at the payload situation itself, you could have upward of $200 million right there, just in the payload cost. On top of that, you would have loss of revenue and consequential damage claims, in addition to which some of our commercial carriers have been selling off transponders. Those transponders could go for as much as $10 million, so the worth of that satellite could be, rather than $50 million, $200 and some-odd million dollars. So, you have a potential of lawsuits that could well exceed insurance limits. Now, we have made a judgment that the risk to the Government if the Government were to indemnify, is very, very small. That is a judgment we have to make—both that the incident would occur, and second, that there would be the type of recovery I have indicated.

However, contractors say:

> Well, that is fine for the Government to take that position. If the Government does suffer a loss, why, the Government would still continue. However, if we suffered the loss, we could very well be out of business.

And so they have that concern. I think it is a legitimate concern for a business to take. It is for that reason that we have proceeded with the indemnification.

Senator **Grassley**. When you say, as you previously did, that you are going down the road toward overall indemnification outside the shuttle area, what do you mean?

Mr. **Hosenball**. No, sir, I am not going down that road as we have not had any situation on our other activities as far as indemnification is concerned. The launch activities are the ones that cause the greatest concern because of the nature of the activity. It is unlikely that we would probably indemnify other kinds of activities, but, if there is a future program that would require it, it would then be considered to be expanded beyond the space transportation system. But it is a launch activity that causes the greatest concern.

Senator **Grassley**. Have you given any thought to catastrophic loss situations?

Mr. **Hosenball.** Arising out of what? I think that is the key. Is there the potential for catastrophic loss in some other area. Currently, we do not see any.

Senator **Grassley.** Well, what about, for instance, the loss of a shuttle within the United States, as opposed to outside the United States, going down—anything like that, causing an extreme amount of property damage, personal damage, that sort of catastrophe.

Mr. **Hosenball.** We do have authority to indemnify our users. We have special statutory authority for that. The reason we did that is we had what we call small, self-contained payloads that are used for experimental purposes, also used by industry as well as by universities, and even some high school students and the rest of them, in addition to which we have other payloads that are experimental in nature, and it would have been very difficult to encourage people to fly on the shuttle where they are paying $10,000 for a small, self-contained payload and would have to pay, say, $50,000 in insurance premiums.

So, we made a case—which Justice, incidentally, supported us on—that we did have special circumstances. As part of that legislation, under our law and services agreement, the user, the commercial user, obtains insurance of $500 million. We think that that may increase fairly shortly to cover for damages on the ground, as you pointed out. The U.S. Government is a named insured in that policy. The quid pro quo for the indemnity over and above that insurance is the fact that we are a named insured. So if something were to happen overseas under the terms of those policies, the insurance would cover and handle those claims, both against the commercial carrier as well as NASA and the U.S. Government. in addition, most contractors will still continue to have coverage below where our indemnity would pick up, to cover them against landing of a shuttle and damage on the ground or to people on the ground.

Senator **Grassley.** Thank you very much.

I would like to turn now to Mr. Robert Wojtal, who has served as attorney-advisor to NASA since July of 1968. He cochaired, as well, the Office of Federal Procurement Policy of the Interagency Task Force on Indemnification, which was established in 1981. That task force completed its study, dated January 28, 1982, recommending Executive Order No. 10789 be amended to expand the authority for contractual indemnification to all situations which could involve catastrophic loss defined as liability above the level of available insurance.

I want to thank you for coming, and would you proceed on the same basis that Mr. Hosenball did?

Mr. **Wojtal.** Yes, I will, Mr. Chairman.

Good morning. I will submit my statement for the record and summarize it, if I may.

Basically, I cochaired an OFPP task force consisting of 10 members. Nine were from executive agencies, and one was from the General Accounting Office. We made a study, basically, trying to determine if there was a need to obtain greater indemnification authority to protect our Government contractors. And indeed, in our investigation, we basically looked at and requested that Government agencies respond to a questionnaire that we sent them. Thirty-five agencies were asked if, indeed, contractors had not bid on their contracts because of the lack of indemnity authority, and we asked if they had exercised under the rule of necessity the inherent authority that an agency might have to indemnify. We received 19 responses. Based on these responses, the task force concluded or recommended that Executive Order No. 10789, which implements Public Law 85-804, be amended. Essentially, what we thought was important was that all executive agencies be given the opportunity to determine that, in a particular instance, a contract would facilitate the national defense and an indemnification of that contractor would facilitate the national defense.

Second, we recommended that the Executive order be amended because it was actually a burr, if you will, in the side of Government agencies in making a determination that its activity in the popular sense was unusually hazardous. Government agencies were not willing, or would not be able in many instances, to make that determination, and based on the legislative history of Public Law 85-804, that we reviewed, that was not an essential ingredient to agreeing to indemnify a contractor. So, with one dissent from the Department of Justice—and I might say his dissent and discussion helped to sharpen the problem—the Government agencies recommended that we define the particular conditions in which a Government agency could indemnify as one involving a catastrophic loss—that is, a loss in excess of the available insurance to a contractor—and not require a Government agency to find that the risk is unusually hazardous—meaning a lethal activity which would likely result in death or damage.

We submitted our report to the Office of Federal Procurement Policy Administrator, Don Sowle. I understand it was distributed to various Government agencies for comment. There was some negative comment presented on the report by several Government agencies.

That completes my summary of the work on the task force, Mr. Chairman. If I could answer any questions, I would be happy to do so.

Senator GRASSLEY. I want to give just a little bit of background as to how we got to this report. In 1977, an interagency governmental task group drafted a bill which was circulated for comment by the Office of Federal Procurement Policy. The bill provided for the establishment of a more comprehensive indemnification scheme, but that bill was never introduced in that Congress. Then, in 1978, the Office of Federal Procurement Policy drafted another bill and circulated it for comment, but no further action was taken again. In 1981, another interagency task force was formed under the auspices of OFPP, and you remember that task force, and you gave us your judgment on the fact that there is some reaction from agencies. I guess if you were to hypothesize or prognosticate, what would you feel will be the end result of the impact on present policy, or don't you feel you are in a position to do that right now?

Mr. WOJTAL. It is very difficult to do so right now. I think that the report has not been, as I said, favorably received by some very influential agencies. It seems to me that they have to be convinced that there is a real need—which seems to be the key—to indemnify Government contractors before they will change their minds.

Senator GRASSLEY. Is there any sort of convincing—or, how is the convincing going to go on to make them aware of it? For instance, would you expect that contractors not bidding would be what it would take to make the impact?

Mr. WOJTAL. I think clearly, yes. I think that is one of the problems with the indemnification proposals throughout the last 15 years. It is difficult to come forward with evidence that there is a justifiable need for indemnifying contractors. There had not been a large number of contractors who have refused to bid. There have not been, obviously, catastrophic losses.

Senator GRASSLEY. Your task force recommends that Executive Order No. 10789 be amended to expand the authority for contractual indemnification to all situations which could involve catastrophic loss defined as liability above the level of available insurance. What is your definition of the term, "available insurance"?

Mr. WOJTAL. That is a tough question to answer. Since I was working as well on the Memorandum Decision of the Administrator, I guess it is the agency's perspective, really, which determines what is reasonably available insurance in terms of cost. If we start dissipating substantial amounts of an agency's money for purposes of insurance, obviously, it will detract from our mission. We made the judgment that $1 million per launch for one prime contractor of NASA is unreasonable, at least insofar as NASA is concerned. It may not be unreasonable from the insurance perspective, for the people who have the insure against the risk.

On the other end of the pole, I cannot say what is reasonable. If you asked me, in terms of one prime contractor per launch, it would simply be a guess on my part; but, I would think that something under $100,000 per launch might be considered to be reasonable. But again, it seems to me it is the agency's perspective that is important.

Mr. HOSENBALL. If I just may interject, I think it is important to point out that neither NASA nor the administration wish to get into the insurance business. At the same time—and that is why we have said over and above available insurance at reasonable premium—where the premium is unreasonable as related to the risk, as Bob has said, it is a judgment call that the U.S. Government should not pay an exorbitant or unreasonable premium. It does take the exercise of judgment, but we do that all the time in many, many situations.

Senator GRASSLEY. Do you believe, Bob, as posed by the dissent, that the effect of the task force's amendment would be to render the U.S. liable without regard to negligence, or the lack of negligence?

Mr. WOJTAL. If I may paraphrase, would the task force recommendation mean that the U.S. Government would be responsible, even though there was no negligence involved on the Government's part?

Senator GRASSLEY. Yes.

Mr. WOJTAL. Yes. The answer is it would.

Senator **Grassley**. Those are all the questions I have. Do you have any other comments that you want to make, either one of you?

Mr. **Hosenball**. No, I do not.

Mr. **Wojtal**. No, Mr. Chairman.

Senator **Grassley**. I can do no more than thank you. And also, let me make an announcement before you leave the table, for other witnesses, as well. Even though the other subcommittee members are not here, it is very traditional for Senators to submit questions in writing, and if they so do, we would appreciate your responses to them. I think it is normal procedure for us to keep the record open for about 15 days. That 15-day period would also give opportunities for either you or any of the other witnesses, or anybody who was not invited to testify, to submit written testimony, as well.

Thank you very much.

[Prepared statements of Messrs. Hosenball and Wojtal follow:]

## PREPARED STATEMENT OF S. NEIL HOSENBALL

Mr. Chairman and Members of the Subcommittee:

This statement supplements my written statement of December 2, 1982, to this Senate Subcommittee on the subject of indemnification of Government contractors. I understand that you are particularly interested in reviewing the factors that prompted the NASA Administrator, on January 19, 1983, to authorize NASA contracting officers to indemnify certain NASA contractors and subcontractors involved in NASA space activities. A copy of the Administrator's "Memorandum Decision Under Public Law 85-804" is appended to this statement.

As you probably know, NASA has had the authority for years under Public Law 85-804 and Executive Order 10789, as amended, to indemnify NASA contractors under certain circumstances. NASA, however, did not exercise this authority for several reasons. We were seriously troubled with the condition in E.O. 10789 that NASA must determine that the risk involved was "unusually hazardous" before we could agree to indemnify a contractor. We did not believe that NASA's space activities, themselves, were unusually hazardous. Moreover, in a practical sense, indemnification did not appear to be necessary.

Contractors were willing to compete for NASA contracts without indemnification and insurance was available to them at reasonable terms and conditions. As the Shuttle program went forward through its four test flights, NASA contractors and potential NASA contractors became increasingly concerned with their potential liabilities arising out of the launch of commercial communications spacecraft. They renewed their efforts to obtain indemnification from us. We received verbal comments from some that they may not bid on future NASA contracts if not protected by indemnity, although we did not receive such comments in writing.

Partially as a result of these concerns by NASA contractors, NASA sought an amendment of E.O. 10789 as proposed by the OFPP Interagency Task Force on Indemnification on January 28, 1982. This amendment would have broadened the authority of Government agencies to use indemnification in their contracts. Alternatively, NASA sought an amendment of E.O. 10789 for only NASA's "space activities." The crux of both of these proposed amendments to E.O. 10789, insofar as NASA was concerned, was to authorize NASA to agree to indemnify its contractors without finding that an "unusually hazardous" risk was involved.

However, there are concerns that the proposed liberalization of the authority to indemnify NASA contractors has not been justified; that it would cast the burden of the contractor's negligent actions on the Government; that it would be costly and would result in contractors' using less care in their contract performance since there would be little incentive to make a safe product. There was also the concern that liberalization may result in abuse of that authority and consequential loss of the authority to indemnify.

Immediately prior to the first operational flight of the

Shuttle--STS-5--one major NASA contractor informed us that its third-party liability coverage for space activities solely because of the launch of commercial communication satellites for the next three Shuttle flights (STS-5, STS-6, and STS-7) was to be separately insured at a premium of $2,950,000, a ten-fold increase. This NASA prime contractor informed us that this premium would be passed on to NASA pursuant to the cost-reimbursement clause in the contract. This contractor thus confirmed what we had previously heard from insurance brokers familiar with insuring space activities. We expected that other NASA prime contractors and their subcontractors, on renewal of their insurance for space activities, would be charged a similar exorbitant premium.

Other agencies have noted that the high cost of such insurance is a short-term problem, brought on by the insurers' concerns that, in the event of an accident, NASA's contractors might be held liable for consequential damages in suits by commercial Shuttle users for lost profits. This problem ultimately can and will be cured by inclusion in NASA's contracts with users of clauses waiving subrogation or third-party liability claims. NASA already has entered into fixed-price contracts with users which do not contain such clauses for launches through 1985, however, so that this problem cannot be completely eliminated in the interim until the existing contracts have been fulfilled.

We were not successful in obtaining the amendment of E.O. 10789 before the flight of STS-5. During this period of time, we had been also studying the possibility of using the approach taken by the Federal Aviation Administration in agreeing to indemnify its En Route Traffic Computer Replacement Program contractors. In effect, as we understand the Department of Transportation determination, it defined unusually hazardous risks as including the risk that a relatively safe computer system could malfunction and, even though there was a low probability of such a malfunction, that malfunction had the potential of causing a catastrophic accident, i.e., damage in excess of insurance reasonably obtainable by FAA contractors. I have appended to my statement a copy of the Department of Transportation determination as published in 46 Federal Register 62596-62597 on December 24, 1981.

The NASA Administrator, after conferring with me and other members of his staff, decided to use the approach taken by the Department of Transportation in agreeing to indemnify its contractors. If, during the interim period, NASA expected to continue to obtain competition for its contracts and not utilize its appropriated funds for the costs of liability insurance it regarded as exorbitant, this appeared to be a reasonable action to take, and to take it before the next flight of the Shuttle, STS-6, originally scheduled for launch on January 24, 1983, and now scheduled for launch in early April 1983.

Concerns have been expressed by other agencies, however, whether the FAA action is an appropriate precedent for NASA's action.

NASA is continuing discussions with the other Executive agencies to seek to resolve the problems concerning indemnification of its contractors during this interim period. In addition, from this date forward, all contracts NASA signs with users will contain appropriate nonsubrogation provisions to prevent this problem from arising in the future.

Mr. Chairman, my statement is concluded. I will be pleased to answer any questions you or any members of the Committee may have.

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## MEMORANDUM DECISION UNDER PUBLIC LAW 85-804

Authority for National Aeronautics and Space Administration Contracting Officers to indemnify certain NASA contractors and subcontractors involved in NASA space activities.

1. On July 4, 1982, the Space Transportation System (hereinafter STS) completed its design, development, test and evaluation phase and was declared an operational system of the United States for the transportation of payloads into and out of outer space for governmental and commercial purposes. With the commencement of these space operations, the STS will conduct launch, in orbit and landing activities on a repetitive basis and at an increasing frequency.

2. The initiation of scheduled STS operations at an increasing frequency has dictated a reexamination of the risks in repetitive space activities of the STS and the present availability of adequate insurance at reasonable premiums to manufacturers and operators of the system. While NASA's STS space activities are designed to be safe, and have been proven to be safe, there exists the remote and low statistical probability that a malfunction of either hardware, software or operator error could occur resulting in an accident. This low probability of occurrence, albeit remote, cannot be totally removed. In the event that such a malfunction or operator error led to an accident, the potential liability arising from such an accident could be substantially in excess of the insurance coverage NASA contractors could reasonably be expected to acquire and maintain considering the availability, cost and potential terms and conditions of such insurance at the present time.

3. Pursuant to the authority of Public Law 85-804 and Executive Order 10789, as amended, and notwithstanding any other provisions of the contracts to which this determination may apply, I therefore authorize that certain NASA contractors, as further defined in paragraphs 4 and 5 below, be held harmless and indemnified against certain risks as specifically set forth herein. Accordingly, and subject to the limitations hereinafter stated, cognizant NASA Contracting Officers are authorized to include in prime contracts, described in paragraphs 4 and 5 below, contract provisions for the indemnification of the contractors and their subcontractors at any tier, against claims or losses, as defined in paragraph 1A of E.O. 10789, as amended, arising out of contract performance directly related to NASA's space activities.

4. This authorization is limited to prime contracts, which

have an effective date before October 1, 1984, by or for NASA for:

a. provision of Space Transportation System and cargo flight elements or components thereof;

b. provision of Space Transportation System and cargo ground support equipment or components thereof;

c. provision of Space Transportation System and cargo ground control facilities and services for their operation; and

d. repair, modification, overhaul support and services and other support and services directly relating to the Space Transportation System, its cargo and other elements used in NASA's space activities.

5. This authorization is further limited solely to claims or losses resulting from or arising out of the use or performance of the products or services described in paragraph 4 in NASA's space activities. For this purpose, the use or performance of such products or services in NASA's space activities begins solely when such products or services are provided to the U.S. Government at a U.S. Government installation for or in connection with one or more Shuttle launches and are actually used or performed in NASA's space activities.

6. The risks for which indemnification is authorized are the risks arising under the contracts described in paragraphs 4 and 5 causing personal injury or death, or loss of or damage to property, or loss of use of property. These risks are considered unusually hazardous risks solely in the sense that if, in the unlikely event, the Space Transportation System, its cargo or other elements or services used in NASA's space activities malfunctioned causing an accident, the potential liabilities could be in excess of the insurance coverage that a NASA prime contractor would reasonably be expected to purchase and maintain, considering the availability, cost and terms and conditions of such insurance. In no other sense are the Space Transportation System, its cargo or other elements or services used in NASA's space activities unusually hazardous.

7. a. This authorization may be applied prospectively without additional consideration to existing prime contracts and subcontracts and in new prime contracts and subcontracts which otherwise meet the conditions of this memorandum.

b. Indemnification of prime contractors and subcontractors may be provided under this authorization only when the Government will receive the benefit of all cost savings, if any, to the prime contractor and its subcontractors at every tier.

8. All contract indemnification clauses shall comply with applicable provisions of NASA PR Part 10. The applicable requirements of NASA PR, Part 17 shall be complied with.

9. This authorization is given upon condition that each prime contractor is approved by me and that such contractor maintains financial protection of such type and in such amounts as may be

determined by me in writing to be appropriate under the circumstances. Each prime contractor shall provide a statement of applicable financial protection through the congnizant NASA contracting officer for my review and determination. In making this determination, I shall take into account such factors as the availability, cost and terms of private insurance, self-insurance and other proof of financial responsibility and workman's compensation insurance.

10. When indemnification provisions are included in a prime contract pursuant to the authority of this decision, the cognizant Contracting Officer shall immediately submit directly to the Contract Adjustment Board a report referencing this decision and containing the following information: (i) name and address of the contractor, (ii) cognizant NASA installation (iii) contract number and date, and (iv) a brief description of the supplies or services procured under the contract.

11. The actual or potential cost, if any, of the actions hereby authorized is impossible to estimate since it is contingent upon the remote possibility of an occurrence and extent of loss resulting from certain space activities which malfunction. Such an occurrence may never occur; in the event of a major incident, millions of dollars of damage could occur.

12. I find that this action will facilitate the national defense. In the remote event that the Space Transportation System, its cargo or other elements or services used in NASA's space activities malfunctioned causing damage in excess of insurance maintained by contractors and subcontractors, the resulting excess liability could place the contractors and subcontractors continued existence in jeopardy, making those contractors and subcontractors unavailable to continue to support space activities and the Department of Defense. I note that for purposes of the Defense Production Act of 1950, the term national defense is defined as "programs for . . . space, and directly related activity." (50 U.S.C. App. 2152(d)).

1/19/83
Date

James M Beggs
Administrator

[From the Federal Register, Vol. 46, No. 247, Dec. 24, 1981—Notices]

## DEPARTMENT OF TRANSPORTATION

### FEDERAL AVIATION ADMINISTRATION

### *Indemnification of Contractors who Participate in the Federal Aviation Administration's Computer Replacement Program*

On December 7, 1981, the Secretary of Transportation authorized the Federal Aviation Administration to include in forthcoming Air Traffic Computer Replacement contracts a clause under which the United States will indemnify or "hold harmless" contractors and subcontractors for losses arising out of the use, operation, malfunction, or failure of any hardware or software provided under such contracts. The authority for this action is derived from Pub. L. 85-804 and Executive Order 10789, as amended. Such indemnities will extend only to losses which exceed $500,000,000 per accident or occurrence, and only for the amount or amounts by which such recoveries exceed $500,000,000. The determination of the Secretary of Transportation is, in part, set forth below:

"The Federal Aviation Administrator has requested authority to include a provision in the Federal Aviation Administration's (FAA) En Route Air Traffic Computer Replacement contracts which would indemnify, or "hold harmless", contractors who furnish hardware or software for losses in excess of $500 million per single occurrence. My authority to provide such extraordinary relief is found in Public Law 85-804 which is implemented by Executive Order 10789 as amended.

"Under FAA's En Route Traffic Computer Replacement Program, equipment will be developed to update the present air traffic system. This operational system will be the primary tool used by the air traffic controller to perform a widespread and continuous safety function. This system will have automated control decisional functional capability so that in response to projected increasing congestion in the national airspace system, the potential for human error will be minimized or eliminated. The hardware and software developed for the program will be quite sophisticated, inasmuch as it will possess a fail safe capability, including self-test and evaluation capabilities. The replacement system will be capable of operating 24 hours a day and will possess technical characteristics, including reliability characteristics, which far exceed the technical requirements for hardware and software utilized in most commerical applications of computers. Statistically, there is a low probability of malfunction to the system; however, this cannot be reduced to zero. In the event that a mulfunction leads to an accident, the potential claimants would be quite numerous, and the severity of potential damage could be catastrophic. While the risk of a catastrophic accident may be remote, if it occurs, it could be far in excess of the insurance coverage that reliably and reasonably could be obtained by manufactures in the marketplace for the life of the system.

"Under Public Law 85-804, authority, if in my judgment the national defense will be facilitated by the program, I am authorized to permit the FAA to provide for indemnification by the United States for claims or losses arising out of or resulting from risks that the contract defines as 'usually hazardous or nuclear in nature.' In addition to authorizing such indemnification, I am also authorized to permit indemnification for claims or losses arising out of or resulting from risks that subcontracts (of any tier) define as unusually hazardous or nuclear in nature. The use of an indemnification provision under Public Law 85-804, and the Executive Order, is an extraordinary contractual action and requires that in approving the use of indemnification and circumstances of its use, I take into account the availability, cost and terms of private insurance, self-insurance, other proof of financial responsibility and workmen's compensation insurance.

"I find it will facilitate the national defense if I exercise my authority under Public Law 85-805 and Executive Order 10789 to permit the Federal Aviation Administration to provide for the indemnification for contracts and subcontractors (of any tier) participating in the FAA En Route Air Traffic Control Computer Program under the following terms and conditions:

"1. That each contract which provides for indemnification of a contractor shall be under the terms and conditions specified in Exhibit A.

"2. That each subcontract (of any tier) may include the indemnification provision in Exhibit A upon the consent of the contracting officer. The procedures set forth in Exhibit B shall be accomplished before the contracting officer consents to the inclusion of the indemnification provision in Exhibit A in a subcontract.

"3. That each contract containing the indemnification provision in Exhibit A require the contractor or subcontractor (of any tier) to maintain financial protection in the amount of at least $500 million per single occurrence for a malfunction of the software or hardware provided for under the contract. This financial protection may be obtained through a private insurance or through a self-insurance program."

Exhibits A and B will be made available to interested parties upon request The risks for which indemnification is authorized are set forth in a standard form approved clause as follows:

"For the purpose of this clause and to meet the requirement of Public Law 85-804 and Executive Order 10789, as amended, the risks for which indemnification is granted and provided herein are the risks, occurrence or series of incidents or occurrences, causing personal injury or death, or loss of or damage to property, or loss of use of property, arising out of or resulting from the use, operation, malfunction, or failure of any hardware or software provided under this contract to the Government for its use in the FAA En Route Air Traffic Control Replacement System; *provided that,* payment shall be made under this clause only if total damage recoveries against the contractor arising out of the risks indemnified exceed $500,000,000 per accident or occurrence, and only for the amount or amounts by which such recoveries exceed $500,000,000."

As required by law, notice of this action has been provided to the Chairman, Committee on the Armed Services, United States Senate; and to the Chairman, Committee on the Armed Services, House of Representatives.

Dated: December 16, 1981.

J. E. Murdock III,
*Chief Counsel.*

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## PREPARED STATEMENT OF ROBERT J. WOJTAL

Mr. Chairman and Members of the Subcommittee:

I am Robert J. Wojtal, an attorney-advisor in the National Aeronautics and Space Administration. I understand that this Subcommittee is interested in reviewing the findings of the OFPP Interagency Task Force On Indemnification contained in the report of January 28, 1982, entitled "Indemnification of Government Contractors Against Third-Party Liability Claims." I co-chaired that task force which consisted of ten members, nine of whom were Federal employees in the Executive Branch of the Government and one General Accounting Office employee. The report reflects the personal analysis and findings of each member and does not necessarily represent the views of their agencies. There was one dissent from the report by the Department of Justice representative.

A summary of the Task Force conclusions are:

"1. There is a reasonable justification for amending E.O. 10789, as amended, to authorize all Executive Agencies who may exercise functions in connection with the national defense to agree to indemnify against third-party liability claims under the authority of Public Law 85-804 and subject to the other conditions in E.O. 10789, as amended.

2. E.O. 10789 also should be amended to permit an eligible agency to agree to indemnify a contractor if the particular contract gives rise to the possibility of 'catastrophic losses' which should be defined as 'losses which the particular contractor cannot reasonably protect against through private insurance or self-insurance by the the payment of a reasonable premium or the establishment of or reliance on a reasonable self-insurance reserve.'

3. The head of an Executive Agency has the authority to broadly construe the clause appearing in paragraph 1 of E.O. 10789, as amended, which authorizes the agency to agree to indemnify a contractor whenever in his judgment 'the national defense will be facilitated thereby.'

4. The Task Force is not now prepared to recommend that there is a convincing justification to provide through legislation for the indemnification of all Government contractors. Furthermore, the Task Force believes that if the Executive Order is amended as proposed, indemnification will be made available to most contractors who need the protection of indemnification. Some members of the Task Force believe that legislation should be drafted to reverse the precedent of Stencel Aero Engineering Corp. v. United States, 431 U.S. 666 (1977) and, moreover, to require the Government to indemnify a contractor where the contractor is held liable under the doctrine of strict liability as a result of Government imposed specifications or drawings. However, a majority of the Task Force believed that

> a recommendation proposing such a sweeping change in its United States law should be supported by an in-depth study, but the Task Force did not have the facilities, staff, or time to accomplish such a study. Moreover, such a study would no doubt duplicate the work underlying H.R. 1504, 97th Cong., 1st Sess. a bill 'to provide indemnity for suppliers of products to the Government in certain cases in which such suppliers become liable for loss with respect to those products, and for other purposes' and similar bills which the Congress has had under consideration recently. Finally, we believe such a study should be undertaken by a team representing the various interests affected and not solely representatives of Government agencies."

As the report points out, the impetus for the Task Force study was the Commission on Government Procurement's 1972 report which recommended that legislation be enacted to provide Government indemnification, above the limit of available insurance, of contractors for liability damage arising from a catastrophic accident occurring in connection with a Government program.

In seeking to determine whether there was a further justification to liberalize the indemnification provisions of E.O. 10789, the Task Force sent a memorandum to thirty-five Executive Agencies and, in effect, asked them whether there was a need to indemnify their contractors. The nineteen responses provided some evidence that certain agencies had been required to indemnify their contractors in order to accomplish their mission, although the agencies did not have express statutory authority to indemnify them. This emphasizes the dilemma faced by certain Government employees in contracting for services that were critical to their mission; they were required to indemnify a contractor although the agency did not have express statutory authority to indemnify. Insofar as obtaining evidence that potential contractors refused to bid on a Government contract because of the inability or refusal of a Government agency to agree to indemnify a contractor, there is no proof or written record, although there was some indirect evidence that this may have occurred in the past.

The Task Force recommended that E.O. 10789 be amended in two significant respects. First, the amendment would permit each Executive Agency of the United States to exercise the authority to indemnify its contractors, but only if the head of that agency determined that such an agreement in a particular contract would facilitate the national defense.

Second, the amendment would authorize an Executive Agency to indemnify its contractors if the risks under the particular contract give rise to the possibility of catastrophic losses, i.e., losses which the contractor cannot reasonably protect against through private insurance or self-insurance by the payment of a reasonable premium or the establishment of or reliance on a self-insurance reserve. Under this proposal, the agency would not be required to determine that the risks were unusually hazardous or nuclear risks before it could provide for indemnification.

In summary, the Task Force focused on three questions:

Was there a justification for amending E.O. 10789 so as to broaden the Executive Agencies' use of the indemnification authority? The Task force answered this question affirmatively.

The Task Force then looked at the question whether E.O. 10789 could be amended to eliminate the condition that the risks involved must be "unusually hazardous" before the authority to indemnify could be used. The Task Force answered that this condition could be eliminated or be applicable in the alternative. Finally, the Task Force was asked whether there was justification in the law for broadly construing the concept of "national defense." The Task Force responded that the legislative history of Public Law 85-804 and judicial definitions of "national defense" in other contexts supported a broad construction of "national defense," for the purposes of indemnification.

Mr. Chairman, my statement is concluded. I will be pleased to answer any questions you or any members of the Committee may have.

Senator **Grassley**. Our next witness is Mr. John Geaghan, who represents the opinion of the National Security Industrial Association. The association is a nonprofit association of approximately 300 American industrial, research and educational organizations representing all segments of defense.

Mr. Geaghan, I understand that you personally are out of Boston, Mass., and you may want to tell us which firm you are with. We are pleased that you could join us, and I would like to have you proceed on the same basis the previous witnesses did.

## STATEMENT OF JOHN M. GEAGHAN, FORMER CHAIRMAN, LEGAL SUBCOMMITTEE, NATIONAL SECURITY INDUSTRIAL ASSOCIATION, AND ASSISTANT GENERAL COUNSEL, RAYTHEON CO., LEXINGTON, MASS.

Mr. **Geaghan**. Thanks very much, Mr. Chairman.

I am assistant general counsel for Raytheon Co., which is a company which is a Government contractor, although it is diversified into substantial commercial activities, also. But I am here today on behalf of NSIA, and I appreciate very much the opportunity to appear here and summarize the testimony which has previously been presented to the committee in written form.

NSIA does believe that there is a need for indemnification via legislation in the area of Government contractor liabilities to third parties. By way of background, as all of us know, there has been a tremendous increase in product liability litigation over the past 15 or 20 years that seems to continue to increase in scope both as to liability theories and in the type of damages which are recovered in these kinds of litigations.

There was an excellent Interagency Task Force study, chaired by the Department of Commerce, a few years ago, which was not addressed particularly to Government contractors, but rather emphasized the commercial area. I think that was indeed a very excellent study. It is summarized basically by indicating that the explosion of product liability litigation and the recoveries under these kinds of litigations are perhaps due to three different contributing factors. First there is the tort litigation system itself, where the privity of contract defense has all but disappeared, except in a few jurisdictions; second, the design and manufacturing practices of manufacturers as they get into more complex products--and that is not to say that they are negligent, but simply that the demand for more complex products raises more problems in the area of product liability; third there is the insurance ratemaking practices, which leaves much to be desired from the standpoint of all manufacturers, commercial and Government.

On the latter point, insurance coverage is typically written for manufacturers, both Government and commercial, on the basis of claims incurred. This means that if a Government contractor, for example, is delivering complex systems to the Government, it may have very adequate coverage at the time of manufacture for most types of liabilities in the product area or field. However, as it continues to deliver equipment to the field that continues to be used by the Government, and if an accident should occur, the accident is the measuring time factor for when an insurance company responds. So a contractor can start out with very adequate coverage when it is manufacturing systems, but several years hence, if an accident has happened in that same product area even if totally unrelated to that manufacturer, it can find nonetheless that insurance coverage is either drying up or it is becoming prohibitively expensive. In the meantime, it continues to deliver systems to the field, and at some point in time, it may find itself with a shortfall as far as insurance liability coverage is concerned.

I think that is more apt to be a problem in the Government contract rather than the commercial field because of the types of systems that are often delivered to the Government, whether they are airplanes or missiles or radar-type systems. Many of these products would have the characteristics that while being safe in themselves, typically, nonetheless if an accident does occur, it could be catastrophic in nature as to dollar amount.

It seems to us that, basically, insurance premiums over the past 10 or 15 years have continued to rise very dramatically. In the Government contract field, there are attempts to hold those premiums down, and probably some of the same type of efforts in the commercial area. But in the Government contract field particularly, Government auditors exercise pretty strenuous efforts to have a Government contractor take a larger share of the risk by taking larger deductibles each year, so that it is not unusual for some contractors to have a $1 or $2 million deductible per incident. This becomes a bit scarey in the sense of equipments continuing to flow to the field.

The thing that makes the Government contractor more unique than the manufacturer of commercial products is that the Government, as the customer and as a sovereign, has only given its permission to be sued in certain limited areas. There are whole classes of people who cannot sue the Government, as we all know—the military, civilian employees, and foreign citizens except for the treaty that was signed by the United States and a few other countries having to do with space-launching activities. Generally, foreign citizens cannot sue. Basically, there are also whole ranges of activities of the Government that, irrespective of who the injured party is, the Government cannot be sued under the Federal Tort Claims Act, if indeed the accident resulted from performance of a discretionary-type function, typically, related to national defense, safety, health matters, for example.

So that there is a practical encouragement here, then, it seems to us, as Government contractors, for people to sue the manufacturer of the product; first, because the person cannot sue the Government, or second, the function that the Government is performing renders the Federal Tort Claims Act nonapplicable. Additionally, the Federal Tort Claims Act does require a proof of negligence on the part of a Government employee. That requirement does not include a Government contractor, either. It must be an actual employee of Government, military or civilian. Thus, the case strategy for the plaintiffs in a liability case involving a product delivered to the Government really encourages, as I say, these suits against the manufacturer, rather than against the Government itself.

Now, one might say, "What is wrong with that?" Well, what can be wrong with that, it seems to me, are two categories of cases. First of all, there is a Stencel-type setting—the *Stencel* Supreme Court case—where—if I recall correctly—Stencel as a subcontractor told the Government that a parachute ejection system for jet fighters was defective in certain respects, and asked that certain changes be made. Now, the Government had conducted wind tunnel tests and all sorts of other technical tests and believed for its own reasons that the system was designed correctly. Two separate accidents subsequently happened, one resulting in injury, and the other resulting in death. Certainly, the one which reached the Supreme Court, which was the injury case, was caused by the very defect that *Stencel* mentioned to the Government. Now, that is the type of situation where the Government designed and specified the equipment. It seems to us that in that kind of a situation, where the Government might have very detailed specifications that might even fill this room on a very complex system, specifications that get into form, fit, and function, choice of materials, weight, size, dimension, electrical and mechanical characteristics, a whole range of things, that where the Government requires this specification, and if the contractor delivers a product that meets those specifications—apparently, as in *Stencel*—then the Government should indemnify the contractor.

Second, we have other situations where there are catastrophic-type accidents. It seems to us again, that to the extent the contractor has only limited insurance coverage and if the losses exceed that insurance, then the Government should step in to cover those kinds of excess liabilities. Otherwise, there could be a ruinous situation for the contractor, which indeed could result in the injured parties not having an appropriate remedy which could be realized by collections.

The present situation as to indemnification is inadequate. There is Public Law 85-804, which has been implemented by two Executive orders and is restricted by a combination of the statute itself and those Executive orders to cover only "unusually hazardous events and nuclear events." Now, the problem with "unusually hazardous events" is that the Government agencies usually take the position, if you requested indemnification, that "unusually hazardous" means something that is almost per se dangerous. I think it is difficult, except in a few instances, to make that kind of a case.

We believe that the term "unusually hazardous" ought to be made to cover situations where, even though the chance of an accident is remote—or, less remote than one might think—nonetheless, if it happens, it could be catastrophic in its result.

I think perhaps NASA has used this particular legislation, for the clause you were discussing earlier with Mr. Hosenball. The only other agency that I recall having issued anything similar was the Department of Transportation through its Federal Aviation Agency. There have been some regulations issued for the upcoming new generation of FAA radar for en-route flight surveillance of civilian aircraft. Now, I have not seen the proposal come out on that procurement but the agency is taking a similar view, that is, this equipment is highly automated and that in order to get all competent companies to become interested in this particular procurement that indemnification in excess of contractor insurance coverage will probably be granted.

In considering the need for legislation, I have not heard anyone say that a contractor should be let off the hook if a contractor is negligent in its own right, except maybe if it is a catastrophic-type situation where the contractor does not have the money to respond and there is a concept of protecting the public. In most bills introduced in the past, at least, that I have read—I know there is no present bill we are addressing—in the past, most of these bills were limited to situations where the contractor did comply with the specifications. Indeed, in some of the proposed legislation, there were exclusions for any situations where the contractor was, at least, grossly negligent.

So that basically, we have this legislative need, as we see it, to cover both catastrophic situations and other situations where the Government contractor actually complied with the specifications imposed by the Government.

I think that concludes my summary of this matter.

Senator GRASSLEY. If you could wait until I go and vote, when I come back, I have some questions I would like to ask you.

Mr. GEAGHAN. Yes, indeed.

Senator GRASSLEY. The committee will recess for about 10 minutes.

[Short recess.]

Senator GRASSLEY. Now that I have voted, hopefully, we will not be interfered with for the rest of the hearing.

I would like to continue with questioning of Mr. Geaghan. What is your reaction, sir—and you have heard the Department of Justice's reasoning and argument that there is always so much effort put into a contractor getting an edge to receive Government contracts, and that that fact in and of itself speaks eloquently—according to them—as an argument against expanding the indemnification aspects—what is your reaction to that?

Mr. GEAGHAN. Well, I cannot really point to anything specific that the present situation results in companies dropping out of the Government procurement business, although one hears of that happening from time to time. But I think what the purpose of the legislation ought to be is to remedy a situation which Government contractors think really is anomalous and unfair to them, from the standpoint of the Government being able to describe with great particularity the product it is buying, which you do not typically have in most commercial settings. And I think also, as I had in my written testimony—again, I do not have any statistics to reinforce this argument—but it seems that it probably might well be uneconomical to the Government for contractors to be carrying heavy premiums all the way from the initial suppliers of components on up through subsystems and then through all layers of subcontractors into the prime contract area. I think maybe an analogy might be that some years ago, the Government, through studies it made—and perhaps they were done by GAO—decided that it was economical for the Government to be a self-insurer for equipment the Government owned—for its plants, facilities, test equipment, et cetera—which it loans or rents to Government contractors, that it made more sense economically for the Government to be a self-insurer as to those properties rather than having contractors insure and take out special coverage for them.

I think if this pyramidal effect, which does exist, from suppliers all the way on up were studied, the cost of insurance would really be staggering from the standpoint of the Government essentially paying for these costs. Insurance, like other costs has to be factored into the price, one way or another. Thus, all costs have got to be essentially factored into the price for which the Government is being charged for the product.

So, yes, there is competition for Government contracts; I do not think that should be the answer, though. I think the point should be is this an unfair situation, which we think it is, and whether the Government ought to indemnify only in those two limited situations, first where the contractor complies with all the specifications, and second, in a catastrophic liability situation.

Senator GRASSLEY. You might be able to help us. In this hearing and in the other two, we have been fishing and exploring for some examples of where the Federal Government might actually save some money through self-insurance, so if you would think of any of those, maybe not at this meeting, but if you would think of those, or anybody else in the room, we would like to have that information.

Mr. GEAGHAN. All right. I can think of an actual situation that kind of typifies the layers of insurance that occur, and that was some years ago. A company made a particular component for a jet fighter, which was purchased by the U.S. Government, and as part of the foreign military sales arrangement, was in turn purchased by Australia. I cannot remember what the dollar value for the component was, but it was relatively insignificant to the price of the plane—and the component had something to do with the landing gear. The plane crashed in a landing. That is the kind of situation you must protect against at all levels of contracting. If you are making even a relatively modestly priced component that goes into any equipment that goes into a subsystem that in turn goes into a system delivered to the Government, every manufacturer will have coverage—in differing dollar levels, to be sure. Most of the airframe companies, for example, would carry around $500 million worth of insurance per accident. But that is the kind of coverage that, with one catastrophic accident, can disappear, leaving that company liable in the future for all equipment that is still out in the field. There is not too much you can do about past-delivered equipment, but the problem becomes aggravated each year as more and more systems are delivered for use.

But I will see if I can find out anything more about self-insurance, because I think that does bear study. I think there are some economies, substantial economies, that can be made there.

Senator **Grassley**. The National Association of Manufacturers has a legislative proposal. Have you read that?

Mr. **Geaghan**. I have only read a summary, but I intend to read it.

Senator **Grassley**. Well, then, I suppose at this point, your association does not have a position.

Mr. **Geaghan**. Well, I am representing the National Security Industrial Association, and they have not considered that particular bill at the moment, but we would be glad to make a study of it and give you our further comments.

Senator **Grassley**. I think we would like to have your views on that, if we could.

Does your association keep track of suits brought against them?

Mr. **Geaghan**. Against Government contractors?

Senator **Grassley**. Yes.

Mr. **Geaghan**. Not specifically, we do not. I am aware of some of the suits that have been brought.

Senator **Grassley**. Well, I guess I was speaking just of those people who would be in your association. Do you even have any figures on suits brought against your member industries?

Mr. **Geaghan**. We have not collected that kind of data, Mr. Chairman.

Senator **Grassley**. Well, those are all the questions I have. Is there anything further you would like to say in summary or anything else?

Mr. **Geaghan**. I think that perhaps additional witnesses may be addressing the recent *Lockheed* case and some of the other matters you have raised. I would just simply say on the *Lockheed* case that that really covers a very small class of potential plaintiffs. The decedent was a civilian employee. And while it does open up what was a completely closed door in the past, nonetheless, it seems to us to represent only a small section of the type of plaintiffs that could indeed be suing manufacturers and for which the manufacturers should have a right over to claim against the Government.

Senator **Grassley**. Thank you.

[Prepared statement of Mr. Geaghan follows:]

## PREPARED STATEMENT OF JOHN M. GEAGHAN

The National Security Industrial Association greatly appreciates the opportunity to appear before this Subcommittee to testify in support of the need for legislative and executive action to provide indemnification to Government contractors against the risks of two categories of accidents: first, catastrophic accidents and, second, non-catastrophic accidents for which the Government is primarily responsible from a causative standpoint.

By way of background, NSIA was founded in 1944 at the instance of James Forrestal, then Secretary of the Navy and later the first Secretary of Defense. It is a nonprofit, nonpolitical association of approximately 300 American industrial, research and educational organizations of all types and sizes, representing all segments of defense in all parts of the United States. NSIA's purpose is to foster effective working relationships and communications between industry and the government in matters relating to national security.

The National Security Industrial Association expresses its support for legislation to provide Government indemnity for those contractors supplying products and services to the Government. We believe that such legislation is long overdue and would help very much to overcome serious inequities and problems involving potential product liabilities by Government contractors to third parties which liabilities should in all fairness be assumed by the Government. The need for such legislation is reflected in cases such as Stencel Aero Engineering Corporation v. U.S., 431 US 666 (1977).

While the Government contractor is in a rather unique product liability risk position, it is instructive to review the general problems of product liability associated with all manufacturers in either a commercial or Government procurement setting. It is axiomatic that payments by a manufacturer, whether by way of insurance premiums to cover specific product liability risks or out-of-pocket costs for non-insured risks, must ultimately be recognized as a function in the pricing of products and, as such, is of vital interest not only to the manufacturer but also to its customers, whether Government or commercial.

Insurance premiums covering product liability risks have risen dramatically. In some cases and depending upon the particular product, the increase has been as high as 5000% over the past ten years. With such increases in insurance rates, some manufacturers have opted to increase their risk participation by increasing their so-called retention (deductible) in an attempt to hold down insurance costs and, in some cases, manufacturers have opted to go or have been forced out of business.

That product liability as a field has itself grown in complexity becomes apparent when one realizes that not many years ago product liability cases tended to be associated primarily with products designed for human consumption (i.e., processed food and drink cases involving the occasional insect, piece of glass, metal, or other foreign object).

Historically, the injured party's product liability claim had to be based upon a contractual relationship. Torts (personal wrongs) were viewed as actionable wrongs committed by one who owed a duty of care to another and the concept of an injury caused by a product rather than by a person was rather slow to develop.

We are all generally familiar with the dramatic growth in the field of product liability and its affect on the product manufacturer in recent years.

The causes of the dramatic growth in product liability have been the subject of a number of studies including an excellent report by an Interagency Task Force in Product Liability chaired by the Department of Commerce.

That report concluded that there were three major growth causes in the personal injury and property damage category of product liability:

1. Liability insurance rate-making;
2. Design and manufacturing practices; and
3. The tort litigation system.

The causative effect of these three major causese are aggravated by other contributing causes such as inflation, product misuse, improved worker awareness of legal rights against third parties and an increase in the number and complexity of products in the marketplace.

Liability Insurance Rate-Making

The rate-making aspects of insurance coverage of product liability is a complex subject matter and for purposes of this hearing it would appear sufficient to summarize the Inter Agency

Task Force Final Report as indicating a split in the opinion of various experts as to why premiums covering product liability have escalated so dramatically.

Some experts believe changes must be made within the insurance system for establishing accurate loss experience data in order to establish appropriate rates for product liability coverage. Others believe that the rates for product liability simply reflect the problems stemming from the underlying tort litigation system and from the design and manufacturing efforts required to manufacture more complex products.

Whichever is the correct position (perhaps it is a combination of both), the cost for such premiums or self insurance must be factored into the price of the product whether the customer is a commercial or Government buyer.

### Design and Manufacturing Practices

The legal basis for every product liability suit for personal injury or property damage is an allegation by the plaintiff that some manufacturer (or another seller in the chain of distribution of goods) put into the marketplace an unsafe and defective product.

Some of the causes exposing manufacturers to product liability risk include the failure to properly perform one or more of the following functions: Design and engineering; manufacture - including the choice of materials, component parts and standards of workmanship; testing; installation and servicing; instructions and warnings; sales and advertising.

In addition to the foregoing, courts have also criticized the failure on the part of the manufacturer to assess the public's reasonable expectation of the product's performance from a safety standpoint; the likelihood and probable seriousnes of injury; the obviousness or nonobviousness of the hazards; the elimination of risk without impairing the performance of the product and the customer's willingness to pay a higher price for a safer product.

The following factors have increased the burden placed on the manufacturer to perform properly the indicated functions: The degree of technical sophistication and innovation of the product; the inability of the user to examine the product due to merchandising and packaging techniques; the "hyping" of the product with mass advertising. Certainly, even the reasonable performance of the design, manufacture, labeling and warning functions have been negated by extravagant and uncalled for advertising and other sales pitches.

## The Tort System

Through the years there has been noticeable shift in favor of plaintiffs bringing product liability claims against manufacturers. In the not too distant past, such suits would normally founder due primarily to the then need for establishing privity of contract between the plaintiff and the manufacturer together with the need to prove negligence in the design and manufacture of the product. Since few manufacturers sold directly to the user, privity was a formidable requirement which seldom existed with respect to the user.

The privity requirement has been substantially eliminated both by case law and statute, especially for consumer users. Additionally, the so-called "long arm" statutes now make it relatively easy to sue a manufacturer in the user's home state even if this manufacturer is located in a distant state.

In the past, the requirement for proving negligence, particularly as it related to a comlex product, was not an easy assignment. Gradually, the law developed whereby liability would be imposed in some cases by presuming negligence (sometimes with the aid of res ipsa loquitur). In the 1960's, the Restatement of Torts promulgated a special liability for selling a product in a defective condition which was unreasonably dangerous to the user or consumer or to his property.

The justification for establishing such special liability was based upon a socioeconomic consideration, i.e., that the burden of loss caused by such a defective product is best borne by those responsible for manufacturing or selling the product since such parties can include in their costs any necessary liability to cover such risks. This is sometimes referred to as a "deep pocket" theory.

This concept has expanded via court decisions to the extent that there no longer appears to be a requirement to demonstrate that the product is unreasonably dangerous. This enlarged concept is sometimes referred to as the doctrine of "strict liability" and may be summarized by stating that the defendant's negligent act or omission is not required to be the proven cause of the personal injury (including death) or property damage but, rather, it is only necessary that the plaintiff prove that the product is defective when it leaves the defendant's control and thereafter causes the injury or property damage.

At times this doctrine of "strict liability" is referred to as "absolute liability" or "liability without fault." However, despite the increasing success of product liability plaintiffs which makes it appear to be so, the doctrine does not stretch that far.

The elimination of the requirement of privity of contract and the lessening of the burden of proof to be sustained by the plaintiff, are accompanied by other complicating factors in the field of product liability impacting the manufacturer, such as the absence of a cutoff date in many jurisdictions beyond which the manufacturer is no longer subject to liability for a product-related injury. With certain exceptions, most statute of limitations begin to run when the plaintiff has been injured and not at the time the product was manufactured or put into the marketplace. While the Uniform Commercial Code measures the contract statute of limitations from the date of delivery of the product, certain states refuse to apply that measuring event to so-called "strict liability" cases. In such cases, the statute of limitations is measured from the date of injury. This has produced seeming anomalous product liability cases involving manufacturers of 30- and 40-year-old products.

Other cases appear to indicate that manufacturers are responsible for designing, manufacturing and testing their products not only for their intended use but for any use which might be broadly anticipated. Or to put it another way, some courts have held that the manufacturer should have foreseen reasonable misuse of the product. Additionally, products which have optional safety equipment may, indeed, lock the manufacturer into the position of having sold an unsafe product if it does not contain such features.

Cases involving product liability have not only stretched the entitlement theories to the ultimate but have similarly revolutionized the standards and scope of damages which can be recovered in strict liability cases to include economic loss.

## The Unique Role of the Government Contractor

The Government contractor is typically obligated to perform its contract in compliance with a myriad of drawings, designs and specifications governing such matters as the choice of materials as well as the product's size, weight, form, fit, function and mechanical and electrical characteristics. The so-called family tree of specifications may be voluminous almost beyond belief.

The Government contractor must adhere to these contract requirements and, indeed, is subject to unilateral changes in such requirements ordered by the Government through is Contracting Officer. In most commercial settings, changes of a unilateral nature by the buyer are simply not permitted by the seller but are, indeed, made subject to the seller's approval.

In many cases, the Government contractor furnishes a custom type complex product with which the contractor has no prior experience and which will be operated and maintained by Government personnel. Complex products in a commercial setting are normally maintained by manufacturer personnel or third parties trained by manufacturer personnel.

Additionally, the use to which the product supplied by a Government contractor is put by its very nature creates risks to which a similar product in a commercial setting would not be subjected, e.g., computers and displays which are used in en route and in terminal surveillance of aircraft for Government civilian and military purposes versus the use of similar equipments for air reservations systems.

The application of the "strict liability" theory to a Government contractor operating under the contractual constraints inherent in performing a Government contract places such contractor in an unfair or unreasonable position absent Government indemnification against third party product liability claims.

The unfair position in which the Government contractor finds itself from a product liability standpoint is aggravated by the sovereign immunity doctrine by which the Government can only be sued where it has given its consent to be sued.

This sovereign immunity doctrine virtually guarantees that the Government contractor (and involved subcontractors of all tiers) will be the primary defendants(s) in any product liability litigation involving a product delivered to the Government.

The Government of the United States has given its consent to be sued in very limited situations such as under the Federal Tort Claims Act, the suits in Admiralty Act, the Public Vessels Act and under a few other statutes not pertinent to these hearings.

It should be noted that while the doctrine of "strict liability" has been enlarged to the detriment of the product manufacturer, the doctrine has not been carried over into litigation arising under the Federal Tort Claims Act, even for so-called extrahazardous activities. The Federal Tort Claims Act precludes imposition of liability unless there has been negligence or some form of nonfeasance or misfeasance on the part of Government employees. (Laird v. Nelms, 406 U.S. 797)

This requirement for proving negligence in cases brought under the Federal Tort Claims Act, in turn, causes many plaintiffs, in complicated cases, to pursue a Government contractor under a "strict liability" theory rather than the Government itself when the injury can be associated with a product or service supplied to the Government.

The Manufacturer, as a supplier of military products to the Government, comes under still another disability in the tort field. While members of the Armed Services of the United States cannot sue the Government, such persons, of course, can sue the manufacturer under a product liability theory. The Supreme Court's affirmation in the case of Stencel Aero Engineering Corporation v. U.S. that the manufacturer has no rights over against the Government even in situations where the Government furnished the design and specifications to which the offending product was manufactured has further aggravated this disability.

Congress has evaluated the issue of Government contractor indemnification from time but except for two scattered pieces of legislation, no relief has been forthcoming.

In 10 USC 2354 (implemented by the ASPR and later the DAR), indemnification is provided defense contractors against unusually hazardous risks under research and development contracts, both cost reimbursement and fixed price. This indemnification protects against claims by third parties for injuries, death or property damage to the extent arising out of direct performance of the particular contract and from a risk defined in the contract as being unusually hazardous. Actions or omissions by the contractor amounting to willful misconduct or lack of good faith are excluded from coverage. Similarly, this statutory indemnification covers injuries, death and damage to the contractor's employees and property, as well as damage to Government property.

This protection can be extended to subcontractors with the prior approval of the Contracting Officer with the prime contractor indemnifying the subcontractor and the Government, in turn, indemnifying the prime for the prime's liability to the subcontractor.

Under Public Law 85-804 (50 USC 1431-1435) (implemented by the ASPR and later the DAR), a contractor for any agency (including a number of the so-called civilian agencies of the Government), which agency exercises functions in connection with the national defense may be indemnified against unusually hazardous risks and nuclear risks not considered unusually hazardous under other than research and development contracts. The coverage is subject to the same conditions stated above for 10 USC 2354. Again, the flowdown to subcontractors of all tiers is permitted with the approval of the Contracting Officer under the conditions indicated.

These indemnification provisions require the contractor to exhaust his own insurance coverage prior to the indemnification becoming operative.

In addition to the two statutes providing for indemnification of Government contractors, there is a straightforward reimbursement provision for use in cost-reimbursement type contracts which has been in ASPR and DAR for years. This provision entitled, Insurance - Liability to Third Persons, provides reimbursement to the prime contractor for liabilities to third persons for death, bodily injury or property damage not compensated by insurance arising out of the performance of the contract, whether or not caused by negligence of the prime contractor, unless otherwise provided in the contract or unless caused by willful misconduct or lack of good faith on the part of the prime contractor. There is no comparable clause for fixed-price contracts.

With respect to the statutes and implementing clauses authorizing indemnification, the term "unusally hazardous" seems most frequently used by the Government to describe activities which pose substantial danger that some injury will result despite the exercise of utmost care. Generally, the Government, when requested to indemnify a contractor under either of these statutes, tends to confine its thinking to the risk areas involving fuels and other highly explosive, incendiary and toxic materials; missiles and nuclear materials.

From a contractor's standpoint, it would be most helpful if the term "unusually hazardous" were to be interpreted to include activities which are dangerous in the sense that even though the happening of an accident is improbable or unlikely to occur, it would, nonetheless, be catastrophic from the scope of a resultant injury standpoint, if it did occur, e.g., the use of air traffic control systems for en route surveillance, especially over congested areas.

In the event of a catastrophic accident in either category arising out of the performance of a Government contract, the ultimate liability of either the Government or the contractor can be rather uncertain.

It is obvious that third persons would sue the Government as well as all of the contractors and subcontractors involved with the system or equipment claimed to have been responsible for the catastrophe. Liability, however, if any, on the part of the Government would have to be based upon the Federal Tort Claims Act since the operation of the doctrine of sovereign immunity, whereby the Government can only be sued where it has given permission to be sued, would prohibit any other basis for suit.

A shortcoming of the Federal Tort Claims Act as previously noted is that unless the injured or damaged third party can demonstrate that a Government employee was negligent and that such negligence caused the injury or damage, the Government cannot be held liable. The fact that a Government contractor has negligently manufactured the article which caused the injury or damage will not establish a basis for recovery against the Government.

Furthermore, even if fault or negligence can be traced to Government personnel (in a Stencel-type setting), the Federal Tort Claims Act, nonetheless, exempts the Government from liability if the Government was exercising a "discretionary function". There are many matters which may fall within that exclusion based upon implementation of national programs involving national defense, safety, health and other related factors. Finally, the Federal Tort Claims Act appears to require proof of fault or negligence on the part of the Government employee even in situations where fault without negligence would be imposed on private citizens.

As a result of these limitations of the Federal Tort Claims Act, the Government may well be insulated from liability, thus making it more likely that the injured third parties would seek recovery from the contractors involved. Liability on the part of prime contractors, subcontractors of all tiers and suppliers may be traceable to one or more of them by virtue of a faulty design or defects in material and workmanship - perhaps confined to a small component which is insignificant from a dollar-value standpoint. Whether the catastrophe occurs either during the period of performance of the contract or at a later point in time as a result of the performance of the contract, there is, of course, no way for a Government contractor to limits its liability to third persons.

If injuries are sustained by civilian employees of the Government or by those persons serving in the Armed Forces of the United States, then the likelihood of suit against either the Government prime or subcontractor, or both, becomes more probable since suits against the Government itself would be foreclosed by the Federal Employees Compensation Act and the Veteran Benefits Act, respectively.

Suits by foreign nationals against the U. S. Government are similarly foreclosed as a matter of law since the Federal Tort Claims Act excludes claims arising in a foreign country. Neither can the U. S. Government be sued against its will in a foreign country by nationals of that country.

Suits are possible by foreign governments on behalf of its citizens against the U. S. Government in the International Court of Justice or before a commission established after diplomatic consultations.

In the area of liability by the contractor for his product, there has been a trend away from the need for proving negligence on the part of the manufacturer towards imposing liability irrespective of lack of proof of negligence, i.e., liability without fault. This principle would apply not only at the prime contractor level but to any subcontractor or vendor supplying an improperly made component.

Certainly, many of the products supplied by a Government contractor could be classified as a product to which would attach the principle of liability without fault. The law is still developing in this area and will vary from state to state but the trend is unmistakably there.

From the general public's standpoint, it should be noted that in the absence of the theory of liability without fault, there otherwise would be great difficulty in some cases proving that a contractor had been negligent. This is particularly true if the cause of the catastrophe is itself destroyed by the catastrophe or is unavailable to the parties for analysis and examination because of military security requirements.

Absent indemnification by the Government, insurance coverage may well be inadequate in some cases due to economic realities. This situation might create the anomaly of liability to third parties in amounts that could bankrupt the contractor and yet leave large portions of the losses of third parties uncompensated due substantially to the insulated position of the Government from liability to such third parties.

The existing indemnification statutes have serious shortcomings in that Public Law 85-804 is limited to agencies which exercise functions in connection with the national defense and while a number of civilian agencies are listed, the Government, nonetheless, tends to take a narrow view of situations constituting "unusually hazardous risks". Additionally, 10 USC 2354 applies only to research and development contracts of the defense establishment, i.e., it does not apply at all to production contracts nor to any type or contracts of nondefense agencies involving activities which are equally or more hazardous than many defense activities.

Thus, contractors are now substantially exposed to many potentially staggering liabilities with no adequate means of financially protecting themselves while at the same time the public has no assurance of receiving adequate compensation upon the occurrence of such a catastrophic accident.

In connection with catastrophic type accidents, it should be noted that product liability insurance coverage is written typically on a "claims incurred basis". Thus insurance coverage in amounts which appear adequate to cover product liability at the present time might be rendered economically unavailable in the future by a single catastrophe. The fact that a contractor had adequate product liability insurance coverage when it manufactured equipments or systems for delivery to the Government does not matter since the critical factor is the point in time when an accident occurs which causes damage. Thus, Government contractors continue to supply equipments and systems which are used by Government civilian and military employees for many years subsequent to their manufacture thereby creating potential product liabilities which defy accurate measurement. Should an accident occur, the date of the accident and not the date of manufacture is the significant event from a product liability insurance coverage standpoint. Conceivably at a point in time when such an accident occurs, the contractor's product liability insurance coverage which was adequate during the manufacture of such equipments and systems could have been severely reduced by a catastrophe unrelated to the manufacturer's own products.

Quite apart from the special need to indemnify Government contractors against a catastrophic type of accident, the Stencel case ought to be instructional as to the need for legislative action. Certainly it seems only fair that when a Government contractor or subcontractor has furnished a product or rendered a service in compliance with the contract requirements, the Government ought to indemnify that contractor against liability for accidents to third parties.

The corollary is that a contractor or subcontractor would not be indemnified in those cases where the injury-causing product or service resulted solely from the primary and active negligence of the contractor or subcontractor. If there are cases of mixed liability vis-a-vis the Government and its contractors, such matters could be resolved by using the doctrine of comparative liability.

## Conclusions and Recommendations

The present product liability situation vis a vis the Government and its contractors and subcontractors with respect to accidents resulting in third party claims is anomalous and unfair to the Government contractor and subcontractor and is probably uneconomic to the Government.

The anomaly results from situations in which the Government can specify its needs with great particularity and can control the design and performance characteristics by insistence upon strict compliance with all contract requirements. The contractor must perform the contract satisfactorily and deliver the product exactly as it is specified. Thereafter, when the product is put into use and even though it fully conforms with the delivered specifications it, nonetheless, might cause an accident resulting in the application of the strict liability doctrine as applied to the contractor. The anomaly is that the Government, in many cases, would initially be liable but for the application of the sovereign immunity doctrine or statutory provisions nullifying suits against the Government by civilian and military employees of the Government. The application of this same doctrine and statutory provisions would normally preclude suit over against the Government by its contractors and subcontractors when they claim indemnification on the grounds that they did only what the contract required them to do.

The unfairness to the Government contractors and subcontractors stems substantially from the fact that the Government as a customer acts in a dual role. The Government acts first of all as a contracting party, but acts also in a second role as a sovereign. In dealing with the Government, contractors and subcontractors must accept many actions performed by the sovereign which financially impact their performances of Government contracts. Thus, the Government may act with relative impunity in many ways which would not occur in the realm of commercial contracting. Many of these Government actions occur in the areas of socioeconomic relationships which impact substantially the costs of performance. These actions by the Government are generally perceived to be for the common good and are accepted as such by contractors and subcontractors.

It is submitted, however, that product liability claims by third parties against Government contractors and subcontractors in many cases are asserted simply because there are classes of people who cannot sue the Government and there are other classes of people who could sue the Government but who choose not to do so for legal strategic reasons. Legislatively this makes for a very unfair situation from the standpoint of Government contractors and subcontractors.

It is submitted that the present product liability situation with respect to Government contractors and subcontractors may be an uneconomic one from the standpoint of cost to the Government. Product liability insurance coverage is a cost like any other cost of performing a Government contract. It is common knowledge that premiums have been escalated dramatically for product liability coverage and basically, as these premiums increase, companies who perform Government contracts must price these premiums into their costs of performance. There is pressure each year by Government auditors for companies to take larger and larger deductibles in an effort to keep insurance costs within reasonable bounds.

From the Government's standpoint, insurance costs as a function in pricing have a pyramidal effect since such costs flow upward from the many tiers of contracting and subcontracting. Even manufacturers of relatively low priced component parts feel compelled to have insurance coverage since the failure of such a part could expose that company to substantial liabilities for personal injury and property damage associated with an expensive equipment or systems. Such lower tier subcontractor may simply be following a Government sponsored design for the particular component part. Thus, if every level of supplier and subcontractor on up to the prime contractor insures its respective products, there is a pyramidal cost effect which may indeed be uneconomic from the Government's standpoint.

Some years ago, the Government made a decision to become a self insurer with respect to its own property which is furnished to Government contractors and subcontractors. While such loaned or rented Government owned property is in the position of a Government contractor or subcontractor, the Government normally accepts liability for loss or damage to that property "under normal perils" and instructs the contractor or subcontractor not to insure against those perils which would normally otherwise be covered by insurance. This arrangement as a self insurer of its own property has apparently been an economical one from the Government's standpoint. It may be that the same kinds of savings are available in the field of third party product liability in the event the Government would agree to indemnify its contractors and subcontractors for the indicated risks.

In concluding this formal statement of NSIA, we would like to express our appreciation for the efforts of the Subcommittee and their timely consideration of the need for indemnification of Government contractors. We endorse this initiative and recommend early enactment of such legislation.

If the Association can be of further assistance to the Subcommittee or its staff, we trust that you will not hesitate to call on us.

Senator **Grassley**. Our next witness is Mr. David Bowman, who is counsel for the Harris Corp., Government systems sector, and that is out of Melbourne, Fla. The Harris Corp., as many of you may know, is a maker of electronics communication, information, data-processing equipment, and it is my understanding that about one-third of their sales are to the U.S. Government.

Mr. Bowman, we are pleased that you could join us, and look forward to your testimony, and ask you to proceed on the basis that I instructed other witnesses to do.

Thank you very much.

## STATEMENT OF DAVID W. BOWMAN, COUNSEL, GOVERNMENT SYSTEMS GROUP, HARRIS CORP., MELBOURNE, FLA.

Mr. **Bowman**. Thank you, Mr. Chairman, and I have submitted written testimony for the record. I would like to cover that briefly and maybe hit some high points. I also have some comments concerning the *Lockheed* case.

But if I may, I would like to sort of set the trend for my comments. I think that the principal concern of companies like Harris Corp. is the state of product liability law in this country today, which I want to emphasize is a State-made law, not a Federal law. Our principal concern is the rule in strict liability in tort, which I believe has been described to this subcommittee in the past. I want to make sure you understand that this rule, as laid down by the State courts, is principally a prorecovery rule. It is liability without fault. As a lawyer, I can safely say that in this country, a manufacturer absolutely insures that his product will not hurt anybody. I think this is not an overstatement of the law, and it is a situation that is a particular problem for a Government contractor, and I will explain why.

I think in the past, you have received testimony to the effect that in the area of contractor indemnification, contractors should and do have the creativity in designing their products to avoid safety hazards. I think this is true in the commercial segment. In my written statement, I have given you illustrations of how this is questionable in a military environment, and I can summarize that by saying you have to consider whether a warning label on a cockpit of a B-1 bomber, which says, "Caution: Follow the Owner's Manual Precisely," whether that is going to achieve a military objective.

In a commercial environment where we are selling an aircraft, we certainly would recommend that kind of a warning label. On the B-1 bomber, I think it has been proven that that would affect the morale of the pilot, as well as the military objectives at hand.

That is an oversimplification, but again, I must take exception to those who say that Government contractors have that ability.

I would also like to emphasize that the Government is in the designing business. We see it every day at Harris Corp. In the typical build-to-print detailed manufacturing drawing that we often bid on, down to the piece-part level, there are inherent restrictions on our being creative in areas of safety. Also, in the typical performance specification, the Government frequently describes in a narrative fashion the capabilities of the weapons system or the equipment.

Now, I do not want to leave you with the impression that Harris Corp. objects to this Government prerogative. I think that we join many who support a typical Government customer who does have a military objective.

The point I am trying to make is that in the strict liability in tort environment where a manufacturer is absolutely liable for the deficiencies in his product, if you take that rule and apply it in a Government environment, you can see the anomaly of the situation and the hopelessness of a Government contractor in protecting himself.

I would like to comment briefly on the *Lockheed* decision. I believe the gentleman from Crowell and Moring also will comment on that, but I feel compelled to make certain observations.

As you know, the famous *Stencel* decision, a 1977 Supreme Court case, involved a serviceman who was injured when he ejected from a fighter aircraft. He sued the manufacturer, and the manufacturer sought contribution from the Federal Government. As a matter of fact, I think the facts in that case were that the manufacturer had warned the Federal Government about certain safety deficiencies in the ejection system, but the Government was not willing to make those changes.

The Supreme Court in *Lockheed* has taken that decision, and I believe has strictly construed it to mean that in a military environment involving a serviceman, where you have a unique Federal purpose, the U.S. Government should not be sued by Government contractors who are liable to those servicemen, but in a civilian environment which is, by the Court's definition, not Federal in nature, that bar should not hold, and of course, the facts in the *Lockheed* decision are that a Navy civilian, or survivors of a Navy civilian injured in a C-5 accident in Saigon sued Lockheed, and according to the Supreme Court, Lockheed may have an indemnification action over or against the U.S. Government.

At Harris, we find this illusory. On our equipment, both servicemen and civilians operate equipment side by side, and in our situation, we find the distinction a little difficult to understand.

The other feature of the *Lockheed* decision that still bothers us is that I think there is some question in prior precedent as to whether the Federal Government is liable at all in a strict liability-type claim. Under the Federal Tort Claims Act, the way that has been defined, I think the rule has been laid down that the Federal Government is liable for negligence. Strict liability, as I have said before, is not a negligence doctrine; it is an absolute liability doctrine. So I think that question is still open.

In closing, I have commented in my written statement relative to the NAM proposal. Harris, I believe, endorses the concept of the

NAM bill. If you read it and understand it, I think you will see that it is different than the previous bill, which I believe was introduced in the 1st session of the 97th Congress—I believe that was H.R. 1504. It is different in that it purports to establish a sharing of liability or a comparative liability concept, whereas H.R. 1504, by the words of that bill, seem to put predominant risk on the Federal Government. In other words, if it were a federally sponsored program, the Federal Government would be liable in an indemnification action.

We endorse the NAM position. We think it is a good compromise, and although you may wish to quarrel with some of the words of that bill, we think that it is headed in the right direction.

That concludes my statement, thank you.

Senator GRASSLEY. Has Harris Corp. had any suits filed against it in its capacity as a Government contractor?

Mr. BOWMAN. Do you mean of a product-liability nature?

Senator GRASSLEY. Yes.

Mr. BOWMAN. Yes, we have.

Senator GRASSLEY. Quite a few?

Mr. BOWMAN. Not quite a few, and I want to speak frankly about that. We look at it from a risk-management standpoint. We can handle the day-to-day, almost expected, claims activity. We are adequately insured for that kind of contingency. We are not so sure about a catastrophe, and in that situation, of course, it is conceivable that the net worth of our corporation could be at stake.

Also, I have to say to the subcommittee that it has been our experience that when we undergo a series of claims or accidents or occurrences within a given period, the following year, our insurance rating goes up significantly and, strangely enough, never comes back down; it is a cumulative problem.

So there are some unfortunate aspects of that.

Senator GRASSLEY. I want to comment on the response in your testimony to the contention that Government contractors will go lax in their safety consciousness with an indemnification policy. I think that is a very articulate statement. I guess for the record, at this point, I think it would be beneficial if you would repeat that.

Mr. BOWMAN. I believe the testimony in the past has been that we would tend to grow lax if we knew we could seek indemnification from the U.S. Government. We believe—and I say this advisedly—that in some respects, the U.S. Government designers have a tendency to go lax if they do not share in that kind of liability. And again, there has to be a recognition of a military objective. We understand that, and we support that. But at the same time, we think it is a healthy environment if at least there is a dual responsibility for these contingencies.

Senator GRASSLEY. I have no further questions. I want to thank you for your testimony and invite you to keep in communication with us as work on this legislation evolves.

Thank you very much.

Mr. BOWMAN. Thank you very much.

[Statement submitted by Mr. Bowman follows:]

## PREPARED STATEMENT OF DAVID W. BOWMAN

My name is David Bowman and I am Legal Counsel to Harris Corporation's Government Systems Sector of Melbourne, Florida. Harris is a maker of electronic communications, information and data processing equipment with annual sales of approximately $1.3 billion. Roughly one third of those sales are to the U. S. Government through our Government Systems Sector. Our Government customers and products are diverse including the Navy for automatic test equipment, avionics and aircraft systems; NASA for earth station antennas, receivers and transmitters in support of the space shuttle program; the Army for van-mounted tactical terminals and highly mobile communications gear for satellite transmission or receiving; and the Air Force for various ground and airborne missile and satellite communications systems, including weather forecasting equipment, and major on-board electronics for the B-1 bomber.

I am here today to express concern of Harris as well as other Government contractors, over the almost uncontrolled contractor liability for servicemen injuries caused by defense related products. There are some unique features of product liability law, as applied in most state jurisdictions, which create potentially astronomical and unjustified risk to Government contractors which can be particularly devastating to small- to medium-sized companies. I, of course, am referring to the strict liability-in-tort theory of recovery. As you know, this is simply a pro-recovery rule for the benefit of injured plantiffs, as applied by state courts, which eliminates the need to prove that an injury-causing product was negligently manufactured or that the manufacturer even had a duty toward a particular victim who was injured. This judge-made law, as originally adopted in California in the early 60's, makes the manufacturer liable even if there is evidence of due diligence and a high degree of care in designing and manufacturing the product, even if he wasn't involved in designing the product. I am not here to debate this rule, although I join many who feel that in its uncontrolled state it is one of the true injustices in our legal system today. I am here today, however, to offer to this committee some concrete examples of the product liability pitfalls a

Government contractor like Harris faces on almost a daily basis. We support those who have concluded that remedial federal legislation is urgently required in this area.

In the commercial marketplace, a defendent manufacturer who is sued for selling an injury-causing machine usually has full right to seek equitable indemnity or contribution from third parties who are principally or jointly liable. For example, if we sell equipment to a buyer who makes injury-causing modifications before he resells it, and we are subsequently sued by an injured user, we have the right to seek indemnity from the buyer. Similarly, if we manufacture a product designed by someone else, the designer may be brought into the action if there is a design defect. Most state courts are lenient in permitting such an action-over or impleding as it's called, even if the manufacturer is jointly at fault, in the interest of resolving the matter in the most efficient and straight forward way. These third party claims permit the defendent manufacturer to argue for allocation of risk and indemnity where it justifiably should be found. However, when the federal Government is implicated in these indemnity attempts and becomes a logical third-party target, as for example where it designed all or a portion of a weapon system which caused injury, our legal system begins to break down. The celebrated Feres and Stencil Supreme Court decisions have been cited to this committee in the past and stand for the general rule that the U. S. Government is immune from suits by servicemen directly, and hence by federal contractors indirectly who are sued by servicemen, on the theory that veterans' benefits and civil service compensation acts provide that the Government's exclusive liability is to pay workers compensation-type payments to the employee. The courts have ruled that even though a serviceman can sue a federal contractor in strict liability because he manufactured a defective product to a government design (ie, merely put the product in the mainstream), the contractor may not seek equitable indemnity from the Federal Government regardless of the Government's fault, because to do so would be substantively defeating the exclusive remedy rule. The rule exists, so say the federal courts, because the Federal Government, as the sovereign, has the right to legislate the circumstances under which it can or cannot be sued, and it has not consented to suits of this type. The proponents of this freedom-from fault doctrine add that the Government is a non-profit generating institution, has appropriation and treasury or public funds vulnerability and should be treated as a "special" person. The more perceptive view, however, is that the Government is merely made up of people who can and do make mistakes, are vulnerable to tradeoff decisions relative to safety and can expose as much safety danger to servicemen or innocent third parties as can a Government contractor. The proponents would state that contractors who know they can't pass liability on to the Federal Government will exercise special care in manufacturing products as a necessary economic incentive to avoid costly injuries and suits. Obviously, the con- verse rule would seem to apply as well to wit: if Government design managers and requirements experts have no accountability for safety defects and injuries to users, they would tend to become lax in designing the best and safest products consistent with military objectives.

Make no mistake about it. The Government is in the product designing and weapon specification business. We see it every day at Harris, either in the typical build-to-print detailed manufacturing drawings that are put out on the street for competitive bidding; as well as the performance-type spec which controls the kind of design that we can come up with in satisfying a military need. I will debate with anyone who states that private industry always has paramount design creativity in areas of military safety and user well being. Under the strict terms of a typical Government contract, we must follow the drawings or specifications precisely and unerringly. I should like to give you several concrete illustrations of the practical limits often placed on a Government contractor in protecting itself from strict liability law.

Harris has implemented one of the most creative product safety labeling techniques in our industry. As you know, where known dangers cannot be removed from a product or where directions are required for safe use, a manufacturer can be liable for failing to give appropriate notices and warnings. Our product labeling technique minimizes narrative and emphasizes use of easily understood pictorial illustrations of the safety risks, covering such concerns as electric shock, microwave or radiation burns and gear or machinery cycling dangers. We insist upon warning of the necessity of grounding electrical components and the need to recheck or retest systems before using. We have elaborate written policy on cautionary notices required to be included in operating and maintenance manuals for electronic equipment, warning against cheating interlocking devices or circumventing safety cut-off switches during maintenance operations. However, on several of our major programs where we have attempted to include such cautionary notices for servicemen in Government-specified instruction and operating manuals, we have been ordered by the Government to leave them out. The Government's reasoning for such direction is quite clear. A label such as "Danger, improper use of this equipment may be hazardous" could have very significant morale impact on a serviceman using that equipment and could arguably compromise military objectives in wartime. You may ask, why not be satisfied that we have at least tried to get the Government to permit us to warn--wouldn't this be admissable in a court if an injured serviceman sued? Unfortunately, the rule of strict liability in tort as applied in most state courts makes such due diligence or good faith conduct irrelevant when a user/plaintiff is injured. Again we become liable merely as a result of marketing a defective product or failing to warn of danger regardless of our attempts to remedy. This is the state of this court-made law in this country. It is, of course, the case that if we delivered product with the rejected warning labels, the product or associated manuals would also be rejected and we would be technically in default. The Government's military needs are paramount and our ability to be creative in avoiding liability is essentially ineffective.

We have found that even when overriding Department of Defense Military Standards prescribe safety devices for military equipment, the individual military services frequently countermand those policies in the interest of specific military needs. For example, there are military standards requiring that electronic subassemblies in excess of certain voltage thresholds be guarded from accidental contact, by use of enclosure guards with non-bypassable or non-cheatable interlocks. This standard would result in the electric current being automatically shut down in the event the protective device or guard is taken off of the exposed contact. However, on specific military programs, contractors are frequently requested by military customers pursuant to specific detailed equipment specifications to render such interlocks bypassable so that, for example, a circuit can remain hot even though the guard is taken off during maintenance or checkout. This is a cheating technique frequently used by TV servicemen, for example, when the back panel of a TV set is taken off. Normally this would close down the power but TV repairmen have little devices they use to keep the power on nonetheless. Direction from a Government customer to design a similar feature must be complied with under a Government contract and, again, the only recourse is to actively discourage such hazards. However, as I have said before, due diligence is not relevent in a strict liability action by an injured serviceman.

Frequently, the military prerequisites of tactical weaponry and equipment make user safety considerations secondary. Harris, as well as other telecommunications companies, manufactures satellite and communication links for use in the field in support of peace-time military maneuvers or eventual conflict. These are van-mounted portable terminals or dishes and require the use of extremely powerful microwave frequencies. Any safety expert knows that if microwave emmissions become uncontrolled by way of a leak or partial damage, bystanders over a very wide range could be seriously injured or burned from these emissions. In a commercial environment, it would not be unusual to build into the system a fault alarm monitoring device which would either automatically turn the system off or report with a very loud alarm, in the event a leak developed. Harris has designed and used such precautions. In a military environment, however, where communication between two commands or ground and air forces could be extremely critical, the military may choose to avoid automatic shut-off and other safety devices and instead may want the communication to go through regardless, even with potentially lethal leakage. The hard reality is that, under some military circumstances, user safety may be of secondary importance. The current state of the law of strict liability-in-tort as laid down by various state jurisdictions refuses to recognize these priorities and again the only question for the court or the jury is whether or not the manufacturer shipped a hazardous product. This, in my opinion, violates basic principles of equity and justice.

I could go on with more illustrations, but the point I'm leading up to is that a product liability claim against a Government contractor involving a dangerous product designed or sponsored by the Government should not be subject to the exigencies of state law. These laws have entirely different interests and goals, such as pro-recovery policies and pro-safety incentives for manufacturers. Simply stated, state law imposes an absolute duty on manufacturers to safely design and carefully manufacture products; I have outlined circumstances here under which federal agencies may require manufacturers not to do that. I must say that we can all see the importance of keeping military objectives paramount sometimes at the expense of user safety. My only point is that you can't reconcile military objectives with contractor liability risk except by well-written federal legislation on the matter, since what we are talking about here is a federal, not a state issue.

Before proceeding further, I should comment briefly on the Lockheed Aircraft Corporation decision handed down by the Supreme Court several weeks ago. That case involved a suit by survivors of a Navy civilian killed on the C-5A aircraft that crashed in Saigon in 1975. Lockheed was sued for manufacturing a defective product and, in turn, sought indemnification from the government. The Government did not dispute that it was primarily responsible for the fatal crash but, relying on previous precedent, sought to dismiss the suit on the theory that it was immune from such civil liability. Under the Feres and Stencil decisions, the Supreme Court had previously ruled that since a government employee or serviceman could not sue the U. S. Government for negligence, a manufacturer of the product who was sued could not seek indemnification from the Government since this would be substantively defeating the negligence immunity rule. As I said before, this long-standing rule had been premised on the exclusive remedy provisions of the Federal Employee Compensation Act which states that an employee or any other person cannot seek damages from the U. S. Government for negligence since the quid pro quo for that preclusion would be a Government no-fault liability under the compensation acts to the employee. Although the Supreme Court's decision in Lockheed continues to be analyzed, many believe that it has opened the door for seeking indemnification and contribution remedies against the U. S. Government by Government contractors. Several jurists have already commented, however, that the case still does not address many of the risks a Government contractor has as I have described earlier and, in fact, may have increased risk to Government contractors. The decision stated, among other things, that the earlier decisions of the Supreme Court in denying indemnity actions were unique in that they involved serviceman or war-related type activity inherently federal in nature; but that there should be no bar against a manufacturer seeking indemnification with regard to injuries to civilian Government employees. This distinction may be illusory. At Harris we have seen both servicemen and civilians operate our various telecommunication and electronic equipment side by side. The Supreme Court's decision may still require further clarification by legislation. In addition, the case still leaves open the question of whether Federal or State law ought to control in resolving these accidents involving federally-owned property. As I said earlier, the state laws have applied in the past and present a very mixed bag in terms of rights and liabilities of the Government contractor/manufacturer. The Supreme Court in Lockheed went out of its way to state that it was not ruling on any kind of federal indemnification or contribution rule but would leave that issue to the states and local jurisdictions. For example, it is not clear if a manufacturer, under all state laws, can maintain a cross action against an employer when the manufacturer is sued by the employer's employee who is injured on the manufacturer's equipment. It's clear, therefore, that federal legislation is still required to place these Government equipment injury cases into the federal as opposed to state arena and to create one federal indemnification rule which effectively preempts a multitude of state rules.

Another and perhaps more serious issue unanswered by the Lockheed decision is whether an indemnification action, premised on strict liability-in-tort, can be maintained at all against the U. S. Government. One case, Nelms vs. Laird (406U.S. 797) decided in 1972, seems to have held that the Federal Tort Claims Act, under which the U. S. Government has consented to be sued in tort, an action can be maintained only for negligence, not strict liability-in-tort or any other no-fault theory. Therefore, federal legislation is still required to cover this unique recovery theory in order to protect Government contractors.

In closing, Harris feels that the time has come for the Federal Government to act responsibly in these matters. The Federal and State Courts are beginning to react to these indemnification attempts by Government contractors, some favorably and some unfavorably, but none consistently. I'm sure you're aware of the agent orange litigation in the Eastern District of New York where Judge Pratt has established a "Government Contractor Defense" rule by which some manufacturers of the defoliant may be able to have themselves summarily removed from that case. Those defendants may have a complete defense, according to the guidelines set out by the Court, if they can establish that the Government established the specifications, the contractor complied unerringly, and the Government knew of the dangers. This decision may be controversial in that it could mean that injured plaintiffs will be left with no remedy at all. Other jurisdictions have adopted indemnification rules under special circumstances. The point is, however, that federal intervention is in order for the sake of uniformity and logic.

We are aware of several bills which have been proposed in the past one of which is H. R. 1504 known as the Government Contractor's Product Liability Act which was introduced early in the first session of the 97th Congress. More recently, a task force of the National Associaton of Manufacturer's has put together a very comprehensive bill which I believe may be more of a middle ground approach and hence acceptable to a variety of interests. I believe the NAM proposal in the form of a draft bill was presented to this committee last year. I am attaching a copy to my written statement for your convenience. Whereas H. R. 1504 essentially put predominant burden on the Government in indemnity actions (excepting only active or willful misconduct on the part of the contractor) the NAM proposal calls for a comparative analysis of fault, with the Government sharing or contributing only to the extent of its negligence. Under the NAM proposal, Government contractors still remain liable for their negligent acts or fault in carrying out their Government-sponsored programs. I urge this committee to seriously consider this type of legislation. I thank you for this opportunity to present our views and I am ready for any questions you may have.

Senator GRASSLEY. Our last witness is Mr. Fred Souk. He is an attorney with the firm of Crowell & Moring in Washington, D.C., specializing in product liability litigation and legislative work and in the Federal courts in administrative litigation relating to Government regulation.

I want to thank you for taking time from your busy schedule, as I know many attorneys in Washington, D.C., are always busy, and thank you for being with us.

I would ask you to proceed on the same basis as the previous witnesses.

## STATEMENT OF FRED S. SOUK, ATTORNEY, CROWELL & MORING, WASHINGTON, D.C.

Mr. SOUK. Thank you, Senator Grassley, for inviting me. I am very pleased to be here and share with you some of my views about the problems your subcommittee has been looking into. I have worked on these problems and written about them myself, and I would have to add my voice to those who have appeared before you and called for some Federal legislation to solve these problems. I believe like they do, that a comprehensive legislative approach is long overdue.

I do not want to repeat any of the information and analysis that so many of the other speakers have provided. I think they have done a very good job up until now in terms of giving you the scope of the problem and some of the facts about it.

I think I can best assist you and the subcommittee by talking this morning for just a little bit about some of the major recent developments which impact on the problems that you are investigating.

Basically, there have been four major developments in the last year or so that are important to what you are looking into. The first one, of course, is the *Lockheed* decision, to which several have already alluded. It came down from the Supreme Court on February 23. The second important development that needs to be addressed is that there have been about five court cases in the last year or so that have addressed the question of a Government specifications defense that contractors might have in a product liability case, and I want to say a little bit about that. The third development that is important to you is, of course, the NASA decision in January to indemnify space shuttle contractors. And the fourth important development is that last year, the Comptroller General, the head of the General Accounting Office, issued a decision that limits some of the indemnification that contractors thought they had available to them. I will address each one of these in just a moment.

I want to point out one other item of information that I do not think anyone else has mentioned yet, but it is important. It is not really a development, but maybe it is.

Since your last hearing, at which representatives of the Public Contract Law Section of the American Bar Association made a statement, the American Bar Association Committee that was studying various product liability legal problems made a report, and among the issues they considered was the Government contractors' tort liability problems. As you may have heard, this committee recommended that Federal legislation was needed to solve these problems, in a sense, encouraging the efforts that you are making to go forward. At the midyear meeting of the American Bar Association this year, they confirmed that aspect of their committee's report. So, what was said to you by the ABA representatives at your last hearing is now the policy of the American Bar Association, and you have their encouragement.

Before I go briefly into each of the developments and what I feel their impact is on the legislative efforts, I want to make sure that I add my voice to those who have stressed the unique aspects of Government contracting, because I think it is important to understanding these problems and working on these problems that we always keep in mind that Government contractors are in a unique position. The Government has immense economic power, it has special legal powers in the Federal contracting process, and many of its projects are of a special nature—military, state-of-the-art technology, exotic uses of technology. All of that impinges on everything we talk about when we talk about their tort liability problems.

Let me turn to the question of the *Lockheed* case. Several people have commented very briefly. I would like to comment perhaps a little less briefly about it.

As you know, prior to the *Lockheed* case, when military Government employees sued contractors, the *Stencel* case prevented the contractor from seeking contribution and indemnity from the Government. When a civilian employee sued a contractor, a similar rule was in effect in most of the circuits of the United States. These circuits had held that the Federal Employees' Compensation Act's exclusive remedy provision language barred contractors from suing the Government when a civilian employee sued them.

The *Lockheed* case reversed that as far as civilian employees go, and it said that FECA is not a bar to bringing an indemnity case against the Government. But it also said you have to bring your indemnity case under the Federal Tort Claims Act; that is the only mechanism you have. Under the Federal Tort Claims Act, you use the substantive law of the State where the act of omission of the Government is alleged to have occurred. So what that means is after the *Lockheed* case, you can seek indemnity against the Government, but the court will apply whatever State law may be applicable. The laws of the various States on the theory of indemnity vary somewhat. There are some circumstances where they do allow you to obtain indemnity against an employer when his employee is injured. However, they generally put some fairly strict limitations on being able to do this. The most basic limitation is that because this theory shifts all liability from the contractor to the employer, they do not apply the theory unless it can be said the employer is either predominantly, primarily, or actively negligent, and the contractor is only passively or secondarily negligent. So, if there is any mixing of negligence between the contractor and the employer, the theory of indemnity is going to have some problems. Because of that, it is fair to say that the *Lockheed* decision may not be—and I am not saying it will not be, but it may turn out not to be—as helpful as contractors would like, even for civilian employees.

But that does not solve the question of military employees. As Mr. Bowman pointed out, the Supreme Court did comment on the *Stencel* case in the *Lockheed* case. It is in a footnote—and although one Justice, once upon a time, said, "Foonotes do not count," lawyers know that they do count—and in that footnote, they said essentially that *Stencel* is still good law with regard to military employees. So, *Lockheed* in no way solves the military employee problem, and it may not solve much of the civilian employee problem. So it is not any kind of a comprehensive solution to the Government-fault problem which you have been addressing.

Let me turn to the second development that relates to the Government-fault problem. There has been developing in some court cases a doctrine known as the "Government specifications defense." This is a doctrine in a product liability case that says when the Government established the specifications for the product, and all that the contractor did was carry out those specifications, and they had a defect in them, which caused harm to somebody, if that somebody sues the contractor, the contractor will have a complete defense by saying, "The Government did the specifications."

Now, there have been five cases on this just in the last year, and three of them have allowed the defense in the cases, and two of them have not. I think I can sum it up very briefly by saying that the courts took varying views of just how broad this defense ought to be. Some thought it would apply only to wartime activities and weapons that the Government created. Others thought it would be broader and would not have that restriction. So there is some promise that courts will continue to develop policy in these cases, but it is not yet clear how broad it will be.

You might also want to know that there have been several product liability bills introduced in Congress in the last several years, and several of them had this defense built into them as a provision. However, the major bill that got considered last year, S. 2631, Senator Kasten's product liability bill, did not have this defense in it. It was in early drafts, but they took it out. When they reported it out of committee, they did say that it ought to receive further consideration. You are probably aware that Senator Kasten's bill has been reintroduced recently as S. 44 in this Congress, and it is possible that some further consideration might be given to a Government-specifications defense. We will just have to wait and see.

But whether the Government-specifications defense is in the Kasten bill and that gets passed, or whether it is developed by court cases, it will not be the full solution by any means to the problems you have been considering. It is only of limited assistance to contractors for three reasons: First, it is only a product defense; second, it is being applied only where the Government is totally responsible for establishing the specifications—it would not cover situations of mixed responsibility—and finally, it is only a specifications defense, and there are so many situations where the Government is at fault and it is not just specifications. The *Lockheed* case is a perfect example of that. There was no claim there that the Government was at fault because of the specifications. Rather, the Government was at fault because of mismaintenance of the airplane, which caused the crash.

Now, there have been two developments that relate to the second major problem you have been addressing, which is, in the shorthand jargon that everyone is using now, "the catastrophic loss problem." The most important, I think by far, is that NASA recently issued its decision that it would now indemnify its contractors on the space shuttle above the level of their reasonably available insurance, and they will do it on a case-by-case basis.

We have heard from NASA this morning, and apparently, they are going to go forward with this, so hopefully, this will come to pass. Whether it does or not, I think NASA's action dramatizes the need for a comprehensive piece of Federal legislation on this subject. First of all, NASA's action recognizes that there is a need to indemnify contractors in some circumstances. Otherwise, you will not have enough competition for the contracts. Otherwise, if there is a catastrophic event, you could wipe out a contractor who thereafter is certainly not going to be available to participate in providing the Government products and services. The second thing about NASA's action is it accentuates the uncertainties in the present statute that provide for indemnification. For a long time, NASA did not use Executive Order 10789, because they were not sure they could use it. Now they have decided they will use it. This just points out the problem with the presently existing statutes. It is nice now that some contractors that work on the space shuttle are going to be able to get indemnification from NASA, but what about all the other contractors who cannot presently get indemnification for various other projects where it is needed?

The third thing about NASA's action which has not been mentioned to date, is that in announcing their decision in this memorandum, they took the position that the problem of cost, which has been raised by some other agencies, may really not be that much of a problem. In fact, they feel it probably will not be a problem. The reason is that although it is possible there could be a very large dollar problem when an event occurs, in the meantime, before the event occurs, NASA sees that there is money to be saved by indemnifying. I think that is a very important point that needs to be considered when you talk about the problem of catastrophic loss.

So, summing up, I think it is fair to say that NASA's action is welcomed by the contracting community, but it just goes to point up the problem. We need a comprehensive piece of Federal legislation that would address these problems for all contractors.

The second development on the catastrophic loss situation was a decision last May by the General Accounting Office Comptroller General. In that decision, he said that if an agency voluntarily agrees in the contract to indemnify its contractors, without having some specific statute authorizing that, then it would be invalid under the Anti-Deficiency and Adequacy of Appropriations Acts. Now, some agencies have been nice enough to provide indemnification without specific statutory authority—not as many as we would like, needless to say. However, now, that kind of voluntary indemnification looks like it is out the door unless the Comptroller General reverses his opinion, and I believe that some parties have tried to get him to do so. We will have to see how that develops.

Where do we stand, then, in light of these four recent developments? I think on the question of the Government's fault for injuries to its own employees, contractors are, perhaps, a little bit better off today than they were yesterday, but we do not have a completely fair and consistent system. We need a completely fair and consistent system. Cost has been raised as a major problem if you use a contribution approach to create a completely fair and consistent system. I think it can fairly be contended that this may be a false problem because savings will be accomplished by having the Government be safer if you make it pay contributions. It also could be contended that even if there is some cost, it is a cost that is not significant enough to outweigh the fairness and safety considerations that should be addressed. No speaker that has come before you or this subcommittee has denied that the present system is unfair and does reduce the Government's incentive for safety. If cost is going to be a major problem, there are possible alternatives to the contribution approach which could be explored, and I would encourage this subcommittee to look at every possibility.

As far as the catastrophic loss problem goes, it is hard to tell if contractors are better off in light of recent developments or not. Certainly, they welcome NASA's action. But the Comptroller General's decision is a setback. Clearly, a comprehensive approach to this problem is still sadly lacking, and as with the Government-fault problem, the cost specter has been raised by some people. And, just as with the Government-fault problem, the cost may not be significant because, as NASA has found, there can be some cost savings which may offset any future costs of an indemnification.

To sum up, I would only say this country badly needs to have a comprehensive system for these problems. It does not have it now. I urge you to continue your efforts to find a more effective approach than the present one.

And I hope you will forgive me if I end on a slightly lighter tone. You may remember one of our former Presidents sometimes would consult his young daughter regarding events of the day. I also did that in preparation for coming to speak to you. I told my 7-year-old daughter I would be appearing and what it was about. She told her playmates about it, and they talked it over, and they came back to me with this message. She said, "Daddy, certainly, nothing can be more important than for you to get Congress to pass a law to improve the system of contribution and indemnification for government contractors." But they also said—and I must tell you this—that they want you, Senator Grassley, to introduce a bill which would outlaw school on Fridays, and I told them I would put in a plug.

With that, I thank you for listening to me, and if you have any questions, I would be glad to try to answer them.

Senator **Grassley**. You tell your daughter that, due to the position of my conservative political philosophy, I would leave that up to the individual State legislatures.

Mr. **Souk**. I will tell her. Thank you. [Laughter.]

Senator **Grassley**. I had three questions to ask you. No 1, you have already answered in your statement. Another one, you have touched upon, but I would still like to go into it. On May 3 of 1982, I know you are aware that the Comptroller General issued this decision that in essence, the voluntary contractual indemnification clause violated the Anti-Deficiency Act and the Adequacy of Appropriation Act. It is my belief that this decision effectively eliminated the usefulness of voluntary indemnification clauses. Would you agree?

Mr. **Souk**. I am afraid I would. I do not believe it eliminates the use of indemnification clauses where you have special statutes that authorize them, like Pub. L. 85-804. But where you do not have those statutes, I think it is fair to say it wipes out indemnification, assuming they do not change their decision. So I do agree with you.

Senator **Grassley**. I would like to have you explore with me the definition of "unreasonable," and this goes back to last year's bill, H.R. 1504, which provided that indemnification would automatically apply whenever the level of liability of a government contractor reaches "unreasonable proportions." What factors would go into the determination of "unreasonable"?

Mr. **Souk**. First of all, I think what you mean is the proposed bill that the NAM submitted and the proposed amendments to H.R. 1504 that NAM submitted would have allowed for total indemnification above the level of reasonably available insurance. That has always been a difficult subject, and I will not try to delude anyone by saying it is not a difficult subject.

However, it is not so difficult that it cannot be addressed. Indemnification, everyone agrees, should not be given for what can be handled by the private marketplace. Mr. Hosenball, just this morning, was explaining that as the Government's point of view.

On the other hand, it is clear that indemnification should be given when insurance is not reasonably available. How do you determine what is reasonably available? Well, it has been done in the recent past, and I will give you an example. The Federal Aviation Administration went through this process, and as I understand from talking to one of their counsel, what they did is they looked at who they had as potential contractors on their new system. They then looked at what insurance these contractors presently had available to them. They did a little bit of investigation to see what level of insurance they might have available a few years down the road, because this was going to be a long-running system. They put all those facts together, and they came up with a number above which they would indemnify the contractors. That happened to be

$500 million for that particular system, and that was based on the fact that they were going to have big companies contracting, and it was based on the fact that they found that in the aviation business there is a certain level of insurance presently available.

This is the kind of process you have to go through in order to determine what is reasonably available. It is a process that requires fact-gathering and some judgment, but it is not a process that is impossible to do, by any means. It can be done, and under the bill as NAM had proposed it, it would be done by each agency in that fashion.

I hope that gives you a little bit of perspective on that.

Senator **Grassley**. Well, Mr. Souk, I want to thank you and all the other participants for today's hearing and their contributions to the record.

[Statement and article submitted by Mr. Souk follows:]

# PREPARED STATEMENT OF FRED S. SOUK

My name is Fred S. Souk. I am an attorney with the Washington, D.C. law firm of Crowell & Moring. In my years as a practicing lawyer, I have worked on and written about the tort liability problems faced by government contractors, and I am pleased to accept your invitation to share with you my views and analysis of those problems.

I do not intend today to repeat the information and analysis presented to you by previous speakers. I do want to state for the record, however, that I concur with the view expressed by many of the speakers that the government contractor tort liability problems being examined by this Subcommittee require a federal legislative solution. For the past year and a half I have been working with a task force of the National Association of Manufacturers which has been seeking to find solutions to those problems, and I believe the draft bill submitted by the NAM Task Force is one possible approach to achieving a balanced and practical solution to the problems.

Over the past year, there have been several developments which bear directly on the problems of government fault and catastrophic loss about which this Subcommittee has been receiving testimony. I would like to provide you with some perspective on these developments and the impact they have on the need for legislation. Before I do, however, I feel it is important that I briefly address some of the special aspects of the government contracting process which form a background for a proper understanding of the recent developments and of government contractor tort liability problems in general.

## The Special Nature of the Government Contracting Process

The tort liability problems which this Subcommittee has been examining derive in large part from the unique features of government contracts as compared to ordinary commercial contracts. The first of these unique features is that for many of its purchases the government is what economists generally refer to as a monopsonist. What this means is that the government, as the primary or only purchaser of certain goods and services, has virtual monopoly power to dictate contract terms and specifications.

Even when the government is not a monopsonist, it nevertheless has special power under federal contract law to dictate the terms and conditions of contracts. Many special clauses are required by law to be inserted into government contracts. One of those clauses is a "changes clause" which enables the government, after performance of the contract has begun, to make unilateral changes in the specifications for the product or service to be provided under the contract. A contractor's failure to comply with those unilateral changes (the expense of which is borne by the government) can result in very severe penalties to the contractor.

Just as important as the government's economic and legal power in understanding the tort liability problems of government contractors is the special nature of projects in which the government engages. Many government projects involve extraordinary tort liability risks either because of the military nature of the project or because of the experimental state-of-the-art technology involved. Contractors who in good faith work on such projects for the government are therefore subjected to enormous potential liability seldom faced in the private marketplace. This problem is exacerbated by the need of the government in many instances to adapt previously purchased products or systems to novel uses which were not contemplated by the contractor or the government when the product or system was originally procured.

These special aspects of the government contracting process require emphasis because they are at the heart of the problems of government fault and catastrophic liability which are the subject of this hearing. With an understanding of these unique aspects of government contracting, it is much easier to grasp the meaning and impact of the recent developments which I will now address.

## The Government Fault Problem and the Lockheed Decision

The first major problem that government contractors face arising from the special and unique characteristics of the government contracting process is that court decisions in recent years have established the principle that contractors who are sued in tort by government employees for injuries arising from government contract activity cannot obtain contribution or indemnity in a third-party action against the government. This means that the government contractor can be held liable for full payment of liability to a government employee, even though it is the government itself that is partially or even completely at fault in causing the harm to the government employee.

As previous speakers have pointed out, the major decision which gives rise to the government fault problem is the case of Stencel Aero Engineering Corporation v. United States,[1] which was decided by the United State Supreme Court in 1977. Stencel, a government subcontractor, sought to obtain indemnification from the government for liability incurred as a result of a personal injury suit bought by a military officer who had been injured when the ejection system of his fighter aircraft malfunctioned. The government had specified the design of the ejection system, and Stencel contended that the defects in the specifications, about which it had complained to the government to no avail, had caused the injuries to occur. The court nevertheless held that the subcontractor could not obtain indemnity from the government for claims made against it by military personnel.

Where the person suing a government contractor for harm arising from a contract is a civilian government employee, the same result arrived at in the Stencel case has been reached in most of the United States Courts of Appeals. These courts have held that contractor suits for indemnity are specifically barred by the "exclusive remedy" provision contained in the Federal

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[1] 431 U.S. 666 (1977).

Employees Compensation Act ("FECA"). The provision states that the compensation provided pursuant to the Act will be the exclusive remedy for the worker and certain "other" parties. The Courts of Appeals have interpreted the "other" category of parties covered by this provision to include contractors. On February 23, 1983, the United States Supreme Court handed down a decision in the case of Lockheed Aircraft Corporation v. United States[2/] which reversed this line of decisions.

In the Lockheed case, the Supreme Court determined that the FECA exclusive remedy provision was not intended to include parties unrelated to the injured government employee. It thus concluded that Lockheed could bring an action for indemnity under the Federal Tort Claims Act against the United States. In its decision, the court cautioned that it was deciding only that the FECA exclusive remedy provision was not a bar, and was not determining whether Lockheed would otherwise be entitled to indemnity under the substantive law of indemnity. Under the Federal Tort Claims Act, the substantive law of indemnity which is applied is the law of the state where the act or omission of the government is alleged to have occurred.

The key factor in understanding the impact of the Lockheed decision on the government fault problem is the extent to which government contractors will now be able to obtain indemnity against the government under the substantive law of the various states. This is a matter which will be addressed by courts in the months ahead and it is entirely possible that there will be varying views given to this aspect of the Lockheed decision and to its overall effect on availability of indemnity.

In most states, indemnity is available, in some circumstances, against an employer for liability arising from injury to his employee. The doctrine of indemnity totally shifts liability from one party to another, and the courts generally apply it only

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[2/] 51 U.S.L.W. 4206 (Feb. 23, 1983).

when the indemnitor (in this case the government) is the party primarily or actively at fault and the indemnitee (in this case the government contractor) is only secondarily or passively at fault. Whether courts will apply the doctrine more broadly in light of Lockheed remains to be determined. If they do not, this aspect of the Lockheed decision will not benefit government contractors in many situations.

The Lockheed decision does not specifically discuss the availability of the doctrine of contribution, but it can be argued that the court's decision also takes away any bar to contribution suits that may have been read into FECA's exclusive remedy provision. Contribution is a legal doctrine which allows one party who has paid a tort liability judgment to a claimant to obtain from another party who is jointly liable to that same claimant the proportion of the payment which is attributable to the fault of the second party. Contribution among jointly liable parties is widely recognized by the states; however, only a very few states allow a contribution theory to be applied where the second party is the employer of the claimant. This is because the second party technically cannot be said to be "jointly liable" to the claimant in light of the exclusive remedy provision of worker compensation statutes which eliminates the employer's liability to his employees. Thus, if courts continue to apply the contribution doctrine in this fashion after the Lockheed decision, the decision will be of little benefit to government contractors in trying to obtain contribution.

It is extremely important to understand that the Lockheed decision involved a case where the claimant was a civilian government employee. In a footnote in the decision, the Supreme Court briefly discussed the Stencel case which, as noted above, barred contribution and indemnity suits by contractors when they are sued by military employees of the government. The court's footnote appears to say that the Stencel decision still will be applicable where military government employees are involved. However, as the dissent suggests, some of the logical underpinning of Stencel may have been eroded, and it is possible that the continuing validity of the Stencel decision will be challenged in subsequent cases.

The net result of the Lockheed decision, therefore, can be summed up as follows:

(1) When civilian government employees sue contractors, the contractors will be able to seek indemnity, and possibly contribution also, from the federal government under the Federal Tort Claims Act. The substantive underlying state law of indemnity (or contribution) will be applied, but it is uncertain as to exactly how the Lockheed decision will affect the breadth of the application of substantive indemnity (or contribution) law. It appears that contractors may continue to be unable to obtain contribution or indemnity in many cases where the government is at fault.

(2) When a military government employee sues a contractor, the doctrine of the Stencel case likely will continue to be applied (unless in the future the Supreme Court decides to overrule it) with the result that contractors will not be able to obtain contribution or indemnity from the government.

The Lockheed decision, therefore, will not be a complete solution to the government fault problem which this Subcommittee is addressing. Indeed, a comprehensive legislative solution to the government fault problem could be said to be even more imperative in light of the Lockheed decision. Without legislation establishing a fair apportionment of liability in all government contracting situations, the ultimate result of the Lockheed case could be helter-skelter availability of contribution or indemnity for contractors depending on the fortuity of where the government's fault occurred or whether the claimant involved was a military or civilian employee. Such inconsistent treatment of government contractors would be unfair and serve no worthwhile policy.

### The Government Fault Problem and the Government Specifications Defense

In recent years, some courts have begun to recognize a doctrine in product liability cases which can partially alleviate the government fault problem. This doctrine is commonly called the "government specifications defense." A shorthand description of it would be that a contractor supplying a product to the government will not be held liable in a lawsuit brought by a person injured by that product if the harm suffered by that person is caused by a defect in the specifications for the product which were established by the government.

There have been five cases just in the last year or so in which the availability of this "government specifications defense" has been addressed by various courts in the nation. Three courts embraced the defense for the situations before them, and two courts rejected it.

The first of the cases, and the one which has received the most attention, is the litigation in federal court in New York concerning the herbicide called Agent Orange which was used by the military during the Vietnam conflict. In the Agent Orange case,3/ Judge Pratt of the United States District Court for the Eastern District of New York ruled that when a government contractor is sued by a third party, whether that third party is a government employee or not, the contractor will have a complete defense to the case if (1) the harm was caused by defects in specifications established by the government, (2) the contractor fully satisfied those specifications, and (3) the government knew as much as or more than the contractor about the hazards involved

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3/ In re "Agent Orange" Product Liability Litigation, 534 F. Supp. 1046 (E.D.N.Y. 1982).

in use of the specifications. Judge Pratt provided the defendants in the Agent Orange case with an opportunity to establish the necessary facts for application of this defense in a special trial preliminary to the main trial in the case. The special trial is scheduled to commence in June of this year.

Because of the way Judge Pratt discussed the application of the government specifications defense in the Agent Orange case, some observers were led to believe that the defense, as he envisioned it, would only be applicable to products which constitute weapons or weapons-related material supplied during wartime. Another recent case, however, shows that some courts may not apply such a limitation to the defense.

In the case of Tefft v. A.C.&S.,[4/] Judge McGovern of the United States District Court for the Western District of Washington held that the defense was applicable even if the product supplied is not necessary for the prosecution of a war. He also found that it was not necessary to the application of the defense that the product involved, which in that case was asbestos, had been supplied only to the government.

In contrast to Judge McGovern's views in the Tefft case, in Chapin v. Johns-Manville Corporation,[5/] a judge of the United States District Court for the Southern District of Mississippi found that the commercial availability of asbestos negated application of the government specifications defense. In addition, in the case of Jenkins v. Whittaker Corporation,[6/] a judge of the United States District Court for the District of Hawaii ruled that the government specifications defense could not be applied to an atomic simulator because the product was not a weapon supplied during wartime.

Finally, I would bring to your attention the very recent

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4/ No. C80-924M (W.D. Wash., Sept. 15, 1982).

5/ No. S79-0272(N) (S.D. Miss., Nov. 2, 1981).

6/ Civil No. 80-0195 (D. Hawaii, Nov. 22, 1982).

decision of the United States Court of Appeals for the Third Circuit in a case called Brown v. Caterpillar Tractor Company.[7] There, the court determined that a government specifications defense would be recognized under the law of Pennsylvania. The court's opinion contains a very good discussion of the policies involved in applying such a defense and also a good discussion of prior cases considering such a defense.

It is clear from these recent court cases that there is potential for further development of a government specifications defense. It is equally clear that the various courts are going to take a variety of views on how broadly such a defense can be applied.

Even under the broadest view thus far espoused, the government specifications defense would be only a partial solution to the problems of government contractors where government employees are the injured parties. First, the defense is a product liability defense and has not been applied to provision of services, which is a very significant aspect of government contracting. Second, the defense has been applied only where the government has the responsibility for the specifications and for any defects in those specifications. The defense is not being applied where there is a mixture of responsibility between the government and its contractor for development of the specifications. Third, the specifications defense is, as the name implies, applicable only to defects in specifications. It does not apply in the numerous other types of situations (as, for example, the faulty maintenance in the Lockheed case) where negligent government conduct is the contributing or sole cause of injury to the government employee.

For these reasons, the continuing development of the government specifications defense will be helpful in ameliorating the government fault problem for government contractors, but unfortunately it will not obviate the need for legislation establishing a uniform solution to the government fault problem.

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[7] No. 81-2479 (3d Cir., Dec. 28, 1982).

It should be added that in recent sessions of Congress, a number of bills seeking to establish a uniform federal product liability act have been introduced, and several of them have included provisions for a government specifications defense. The major bill in the 97th Congress, S. 2631, was introduced on June 16, 1982 by Senator Kasten of Wisconsin. The bill has been reintroduced in this Congress as S. 44. Early discussion drafts of S. 2631 provided for a government specifications defense, but the provision was not contained in the bill as introduced. S. 2631 was reported out of committee on September 30, 1982, and the Committee Report states that the issue of including a government specifications defense should receive further consideration. It is possible, therefore, that the defense could be reinserted in S. 44 as it is given further consideration in this Congress.

As noted, however, the government specifications defense has limited applicability. It would not provide a comprehensive solution to the government fault problem being addressed by this Subcommittee even were it included in a federal product liability act.

## The Catastrophic Loss Problem and NASA's Proposed Use of Executive Order 10789

As previous speakers have ably pointed out, the second major problem faced by government contractors concerns the extraordinary amount of liability which can arise from the risks inherent in many government projects. If a catastrophic accident or series of events results from a government project, the liability, and even the defense costs alone, arising from the ensuing lawsuits against the contractors who supply the products or services for the project could easily exceed both the available insurance and the net worth of those contractors. This would, of course, spell financial disaster not only for the contractors involved, but also for victims who would be unable to obtain compensation from the contractors. Although the government *presently possesses* statutory authority to indemnify its contractors for excessive and unreasonable liability in some situations, the authority is not comprehensive, and its use is not mandatory. The government has not been consistent in using the authority. As a result, conscientious contractors increasingly are deterred from participating in essential procurements involving potential catastrophic risks.

Since this Subcommittee's last hearing, there has been a development regarding indemnification of contractors which I believe highlights the need for legislation in this area. In January of this year, the National Aeronautics and Space Administration announced by internal memorandum that it would end its longstanding policy of not using the indemnification authority provided to it by Executive Order 10789. The NASA memorandum stated that henceforth contractors working on NASA's Space Shuttle program would be given indemnity on a case-by-case basis. The memorandum noted that such indemnification was essential in order to insure a continued supply of high quality contract service to NASA.

It remains to be seen whether and to what extent the NASA memorandum will be implemented. Irrespective of whether NASA's new program is fully implemented, NASA's action demonstrates in a variety of ways the need for a comprehensive piece of legislation to establish a uniform federal policy for indemnification of contractors.

First, NASA's action clearly recognizes the most fundamental policy concern which requires government indemnification of its contractors, i.e., without appropriate indemnification competent and conscientious contractors are deterred from participating in procurements. The result, as NASA clearly recognizes, is an unfortunate one. The government may have to face the prospect of not being able to accomplish essential tasks at all, or the expense and timing of essential tasks can be adversely affected.

Second, NASA's memorandum recognizes that, irrespective of any deterrence of contractors to bid on contracts, failure to provide appropriate indemnification for unreasonable liablity can nevertheless have a detrimental effect on the government's ability to procure essential goods and services because, if a catastrophic event occurs, contractors involved in the project could be wiped out and therefore unavailable for further essential work with the government.

Third, NASA's memorandum points out that the cost of implementing indemnification for a catastrophic event is difficult to estimate. It is possible that such indemnification will never be needed. However, if indemnification is required, NASA has found that the cost can be offset by savings to the government. In this regard, it is important to note that broader indemnification should encourage broader competition for contracts and thereby foster lower overall procurement cost to the government.

Fourth, NASA's action highlights the fact that indemnification under Executive Order 10789 is limited and discretionary. While it is fortunate for contractors that NASA has now chosen to make use of its authority, for many years the contractors working on NASA activities did not have indemnification when clearly they should have. As other speakers have previously pointed out, some agencies do not have authority under Executive Order 10789 and those that do have authority have been inconsistent in their willingness to apply the authority in specific circumstances. Such a situation is both unfair to contractors and detrimental to the procurement process.

In summary, therefore, NASA's decision to use Executive Order 10789 accentuates the need to have legislation establishing a comprehensive program. Only through such legislation can the piecemeal and inconsistent approaches under present statutory authority be shaped for optimum accomplishment of federal procurement policy.

### The Catastrophic Loss Problem and the Comptroller General Decision

Various agencies of the government have at times voluntarily inserted indemnification clauses in some contracts without being specifically authorized to do so by indemnification statutes. Section 7-203.22 of the Defense Acquisition Regulation specifies such a clause for use in military cost-reimbursement contracts. A corresponding clause for civilian agency cost-reimbursement contracts is found at § 1-7.204-5 of the Federal Procurement Regulations (FPR).

On May 3, 1982, the Comptroller General issued a decision finding that the indemnification clause contained in FPR § 1-7.204-5 violates the Anti-Deficiency Act, and the Adequacy of Appropriations Act, because it commits government funds for payment of liabilities which are undetermined at the time of contracting and which may have a cost in excess of available appropriations. The decision effectively eliminates the usefulness of voluntary indemnification clauses as protection against catastrophic loss because the amount of liability in catastrophic situations will generally exceed the level of existing appropriations. Unless the decision is modified or reversed, contractors will now be able to obtain effective indemnification against catastrophic loss only in situations where indemnification statutes are applicable.

This development creates an even greater catastrophic loss problem for government contractors, and it constitutes yet another compelling reason for establishing a comprehensive legislative solution.

## CONCLUSION

Recent developments have not altered the acute need for legislation to correct both the government fault and catastrophic loss problems. Indeed, recent developments serve to highlight the unfairness of the present inconsistent and piecemeal way in which these problems are handled.

As regards the government fault problem, no speaker before this Subcommittee has denied that the present situation is extremely unfair to contractors. The government, however, has raised the specter of cost if the problem is solved by allowing contractors to obtain contribution from the government. Serious questions can be raised as to whether there really will be a net cost to the government (because, presumably, making the government financially responsible will result in safer government practices and an accompanying diminution of employee lawsuits) and, if so, whether it is a cost that ought to be accepted. Assuming, however, that cost will occur and should be avoided, there are workable alternatives to the contribution approach which can be explored.

As regards the catastrophic loss problem, both contractor representatives and government representatives (i.e., NASA and the Department of Defense) have agreed that government indemnification of its contractors for unreasonable liability should be broadened. Only the Department of Justice has opposed any expansion of indemnification, and that opposition appears to be based on the cost potential. However, as NASA's recent action recognizes, there may very well not be a net cost associated with broader indemnification.

This Subcommittee deserves much praise for examining these important problems and the possibilities for a legislative solution to them. I urge you to continue in this worthy effort until a comprehensive solution to the problems is achieved.

Thank you once again for inviting me to express my views. I would be pleased to answer any questions you may have.

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# Government Contracts and Tort Liability:

# Time for Reform

BY FRED S. SOUK

## INTRODUCTION

The allocation of tort liability between the United States Government and its contractors for harm to third parties arising from the performance of government contracts has become a subject of increasing notoriety and concern in recent years. The extensive liability potential of many government programs has been dramatized by the mass litigation over Agent Orange,[1] and the unhappy and oftentimes unfair lot of the government contractor vis-a-vis the government is slowly becoming better understood.

Government contractors face two major problems regarding third-party tort liability. First, court decisions in recent years have established the principle that contractors who are sued in tort by government employees for injuries arising from government contract activity cannot obtain contribution or indemnity in a third-party action against the government. Contractors have been held liable for full payment of liability to government employees even though the government itself was partially or wholly at fault in causing the harm to the employees. This result has particular significance for contractors because of the continuing expansion of the doctrine of strict liability which enables injured government employees to sue contractors successfully for product defects which result from specifications and requirements imposed upon the contractor by the government.

The second tort liability problem concerns the amount of liability which can arise from the risks inherent in many essential government projects such as military activity, medical research, use and disposal of hazardous substances, vaccination programs, satellite and missile launching and re-entry, and air traffic control. If a catastrophic accident or series of effects results from such programs, the liability (or even the defense costs) arising from the ensuing lawsuits against the contractors supplying products or services for the programs could easily exceed both the available insurance and the net worth of those contractors. This could spell financial disaster for the contractors and for victims unable to obtain compensation from the contractors. Although the government presently possesses statutory authority

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**Fred Souk is an attorney with the firm of Crowell & Moring in Washington, D.C. specializing in product liability litigation and legislative work and in federal court and administrative litigation relating to government regulation. He is a member of the Federal Bar Association.**

to indemnify its contractors for excessive and unreasonable liability in some situations, the authority is far from comprehensive and the government has been inconsistent in using it. As a result, conscientious contractors increasingly are deterred from participating in essential procurements involving potential catastrophic risks.

Both of the foregoing tort liability problems raise serious questions about the fundamental fairness and effective functioning of the federal procurement process. This article will examine the problems in detail, review the history of proposed solutions to the problems, and explore the need for further action.

## I. THE PROBLEM OF GOVERNMENT FAULT

### A. *The Government Windfall Under Existing Case Law*

In *Stencel Aero Engineering Corporation v. United States,*[2] the Supreme Court ruled that a government subcontractor could not obtain indemnity from the government for liability incurred as a result of a personal injury suit brought against the subcontractor by a military officer who had been injured when the ejection system of his fighter aircraft malfunctioned. The government had specified the design of the ejection system. Stencel contended that because of defective specifications, about which it had complained to the government to no avail, the government should be required to pay all liability incurred by Stencel.

The military officer in *Stencel* was unable to sustain a suit against the government itself. Although the Federal Tort Claims Act does not expressly exclude actions by servicemen injured in the line of duty,[3] the Supreme Court decided in 1950 in *Feres v. United States*[4] that such an exclusion should be implied because of (1) the "distinctively federal character" of the relationship between service personnel and the government; (2) the upper limit impliedly intended to be placed on government compensation to injured service personnel by the Veteran Benefits Act; and (3) the need to preserve military discipline.

In *Stencel,* the Supreme Court decided that the doctrine of the *Feres* case should be extended to bar a claim for indemnity by a government contractor when injured military personnel sue the contractor in lieu of suing the government. The court saw an indemnity action as an indirect violation of the *Feres* policies.[5]

The lower federal courts have reached the same result arrived at in the *Stencel* case in the analogous situation involving injury to civilian government employees who are provided compensation pursuant to the Federal Employees Compensation Act.[6] A good illustration is the case of *Thomas v. Lockheed Aircraft Corporation.* The *Thomas* case resulted from the crash of a C-5 cargo aircraft which was being used to ferry orphans and government employees out of South Vietnam. Injured civilian government employees, and survivors of civilian government employees who were killed, brought suit against Lockheed for a defect in the aircraft.[7] Lockheed attempted to obtain contribution or indemnity from the government based on the contention that the crash resulted solely from the negligence of the government in maintaining the aircraft. The United States Court of Appeals for the District of Columbia Circuit held that the exclusive remedy provisions of the Federal Employees Compensation Act not only prohibit a direct suit against the government by its injured civilian employees but also prohibit contribution or indemnity claims by contractors who are sued by the employees.[8] The Supreme Court has granted Lockheed's petition for certiorari in the case.[9]

The combination of *Stencel* and cases like *Thomas* means that government contractors end up bearing all risks of liability to the great mass of government employees who are the individuals most frequently exposed to harm caused by products or services supplied under government contracts. Contractors must bear liability even though the government was equally or solely at fault in causing the harm. The contractor's problem is exacerbated by the continuing expansion by state courts of the doctrine of strict liability, which enables plaintiffs to recover compensation for injuries caused by products produced by a defendant even though the defects in the product were not the fault of the defendant. An irony of the application of the strict liability doctrine to government contractors is that in *Laird v. Nelms*[10] the Supreme Court held that strict liability principles do not apply to claims brought against the government itself under the Federal Tort Claims Act. Thus, the contractor can end up having to bear the government's liability under a theory which is not applicable to the government itself.

### B. *The Government Specifications Defense: A Partial But Uncertain Solution*

In recent years, some courts have begun to recognize a doctrine in product liability cases which can alleviate partially the problems faced by contractors under the *Stencel* doctrine. This new defense has generally been given the name "government specifications defense," and the most prominent recognition of it has been in the *Agent Orange* litigation.[11]

In *Agent Orange,* Judge Pratt of the Eastern District of New York ruled that when a government contractor is sued by a third party, whether a government employee or not, the contractor will have a complete defense to the action if (1) the harm was caused by defects in specifications established by the government, (2) the contractor fully satisfied the specifications, and (3) the government knew as much as or more than the contractor about the hazards involved in use of the specifications.[12] Judge Pratt provided the defendants in the litigation an opportunity to establish the necessary facts for application of the defense in a special trial (now scheduled to commence in June 1983) preliminary to the main trial.

Because Judge Pratt began his discussion of the government specifications defense with the observation that "courts should not require suppliers of ordnance to question the military's needs or specifications for weapons during war time," observers have questioned whether the government specifications defense as envisioned by Judge Pratt would have application beyond the narrow confines of a supply of ordnance during war time.[13] Another question left open by Judge Pratt's decision was whether the defense would apply where the contractor also supplies the product in a commercial context and the government specifications are merely a pro forma rendering of specifications for the commercial product.

In the recent case of *Tefft v. A. C. & S., Inc.,*[14] Judge McGovern of the Western District of Washington expanded upon the *Agent Orange* version of the government specifications defense. He held that it was "logical" to apply the defense irrespective of the general commercial availability of the product in question (asbestos) as long as the conditions specified in *Agent Orange* were met.[15] He also indicated that he did not agree that the defense was only available where the product was necessary to the prosecution of a war.[16] Finally, Judge McGovern held that the defense applies to tort actions based on strict liability as well as those based on negligence.[17]

The *Agent Orange* case and the *Tefft* case show promise for the continued development of a government specifications defense. It must be noted, however, that some courts have rejected the defense.[18]

In any event, the government specifications defense is but a partial solution to the problems of government contractors in situations where government employees are injured through the fault of the government itself. *First,* the defense, as it is presently developing, is a product liability defense and would have no applicability to the provision of services. *Second,* the defense applies only when the government has responsibility for the specifications. It has not been applied where, as is often the case, there is mixed responsibility for development of government contract specifications. *Third,* it is indeed only a "specifications" defense; it has not been applied to the numerous other types of situations where negligent government conduct is a contributing cause of injury to a government employee.

During recent sessions of Congress, a number of bills seeking to establish a uniform federal product liability act have been introduced, and several of these bills have included provisions for a government specifications defense. The major bill in the 97th Congress, S. 2631, was introduced on June 16, 1982 by Senator Robert Kasten (R., Wisc.), Chairman of the Consumer Subcommittee of the Senate Commerce, Science, and Transportation Committee. Although early discussion drafts of S. 2631 provided for a government specifications defense, the provision was not contained in the bill as introduced. The bill was reported out of committee on September 30, 1982, and the Committee Report states that the issue of including a government specifications defense should receive further consideration .[19] It is possible, therefore, that as further action is taken on a uniform federal product liability act, government specifications defense may ultimately be established by federal law.

### C. *Legislative Prosposals for Resolving the Government Fault Problem*

#### 1. H.R. 1504: THE GOVERNMENT CONTRACTOR'S PRODUCT LIABILITY ACT

A bill specifically seeking to remedy the problems caused by the *Stencel* decision was introduced by Congressman Robert McClory (R., Ill.) (with 14 co-sponsors) early in the first session of the 97th Congress. The bill, H.R. 1504, to be known as the Government Contractor's Product Liability Act, provides that:

> The United States Government shall indemnify and hold harmless the supplier and his insurers for any product liability and loss experienced by a supplier of a product or services to the United States Government unless such liability is determined by the court adjudicating the supplier's liability to have resulted from the primary and active or willful negligence of the supplier.[20]

Hearings were held on the bill on March 19, 1981 by the House Judiciary Committee's Subcommittee on Administrative Law and Governmental Relations. A Congressman, several industry spokesmen, and representatives of the Public Contract Law Section of the American Bar Association testified in favor of the legislation.[21] Subsequent to the hearing, the General Services Administration and the Department of Justice submitted written comments raising questions about the bill.[22] No further action on the bill was taken in the 97th Congress.

#### 2. NATIONAL ASSOCIATION OF MANUFACTURERS DRAFT BILL

On March 15, 1982, a task force of the National Association of Manufacturers submitted to the House Subcommittee on Administrative Law and Governmental Relations proposed revisions to H.R. 1504.[23] Unlike the provisions of the bill as introduced, which call for government indemnification whenever liability does not result from the "primary and active or willful negligence" of the contractor, the NAM draft bill provides for government contribution based on pure comparative fault. Under the draft bill, the government would be required to contribute to payment of liability in proportion to the extent of its fault, however large or small.

The NAM draft bill also provides a set of factors to be considered by the court in determining the comparative fault of the government and the contractor. These include (1) responsibility for contract provisions or specifications; (2) applicable government standards; (3) the role of government-furnished equipment or services; and (4) negligence of government employees. The bill would apply comparative fault contribution principles to contracts for both products and services.

On September 30, 1982, the Senate Judiciary Committee's Subcommittee on Agency Administration held oversight hearings on problems relating to government fault in causing harm arising from government contracts. The National Association of Manufacturers submitted to the Senate draft legislation identical to that previously proposed to the House.[24] The Senate Subcommittee held further hearings on December 2, 1982, and Senator Charles Grassley (R., Iowa), the Chairman of the Subcommittee, announced that further hearings at the beginning of the 98th Congress are under consideration.

### D. *The Need for Resolution of the Government Fault Problem*

Proponents of a legislative solution for the government fault problem cite the following major justifications for overriding the decision in the *Stencel* case and other similar cases:

(1) The *Stencel* doctrine acts as a disincentive to safe practices by the government because the government is able to externalize the cost of liability caused by its own negligent acts.

(2) The *Stencel* doctrine is unfair to government contractors who are required to bear responsibility for harm resulting from government conduct over which they have no control.[25]

(3) The *Stencel* doctrine acts as a disincentive for maximum participation of contractors in the government procurement process.

Of these justifications, the need to promote safety is especially important in the government contracting context. Unlike private industry, the government lacks certain incentives for safety which might otherwise help to overcome the disincentive of not having to pay tort liability. For example, the sanctions applicable to private employers under the Occupational Safety and Health Act do not apply to the United States Government.[26] Another major incentive of private industry for safety, the profit motive, is also lacking in government activities.

In opposing legislative reform, the Department of Justice has stressed the importance of the major policy underlying the *Stencel* doctrine — *i.e.*, that the government should not have to suffer liability, even indirectly, where it has already paid compensation to its employees.[27] This argument, however, fails to address the serious problem of safety disincentives which are unique to the government contracting context. The argument also ignores the unfairness of requiring the government contractor to bear the government's liability.

The Department of Justice has also pointed to the cost burden that would be imposed on the government if it were to have to pay contribution to contractors.[28] It is not clear, however, that requiring the government to pay contribution would result in higher government expenditures. If safety incentives are improved, liability which the government presently incurs, both to its employees for compensation and to non-government employees under the Federal Tort Claims Act, can be avoided. Thus, there could be a net cost savings. Even if there are additional costs involved in requiring government contribution for government fault, the costs would seem to be a reasonable price to pay for the establishment of a fairer liability system which would promote better safety and broader participation in government procurement programs.

## II. THE CATASTROPHIC LOSS PROBLEM

### A. *Background of the Problem*

After World War II, expansion of government programs, especially along the frontiers of technology, greatly increased the potential for catastrophic harm both to the contractors who participated in good faith in such programs and to the public at large. In recent years, the difficulties faced by government contractors in trying to protect themselves against the tremendous liability potential inherent in many types of government programs has been dramatized by such events as (1) Skylab plunging to earth, fortunately causing little harm, but clearly demonstrating the potential for extensive liability growing out of space activities; and (2) former servicemen suing the manufacturers of the defoliant Agent Orange, which was used extensively by the military in the Vietnam War, thereby demonstrating the awesome tort liability potential of all military activities.

### B. *Indemnification Statutes*

The first specific Congressional recognition of the problem of the potential for catastrophic loss growing out of government contracts was the enactment in 1952 of what is now 10 U.S.C. § 2354. This law authorizes the military departments to indemnify contractors engaged in research and development programs for liability which arises from the direct performance of the contract and exceeds the amount of the contractor's insurance coverage. Indemnification can be applied if a risk associated with the contract is defined in the contract as being "unusually hazardous." Indemnification can be paid from funds appropriated for the contract in question or funds generally available for research and development.

The indemnification authority provided in 10 U.S.C. §2354 has several problematic limitations. The authority has only a very limited applicability to non-military procurements.[29] It has no applicability to production contracts. Even for research and development contracts, indemnification is discretionary with the contracting military agency. The indemnification, when given to prime contractors, does not automatically extend to subcontractors. Finally, the authority is only applicable to contracts involving risks which are defined to be "unusually hazardous," a designation that may be inapplicable (or simply unacceptable to the contracting agency) with regard to many situations where there is a potential for extensive liability.

In recognition of the fact that production contracts have as much potential for catastrophic harm as research and development contracts, Congress in 1958 enacted Public Law 85-804.[30] On its face, Public Law 85-804 says nothing about indemnification, but the legislative history makes it clear that indemnification is one of the major purposes for the legislation.[31] The indemnification objective has been carried out by means of Executive Order 10789 which was promulgated by President Eisenhower in 1958 and has subsequently been revised several times by other executive orders.[32]

The indemnification authority under E.O. 10789 allows all military agencies and certain civilian agencies[33] to include, at their option, indemnification clauses in any contract connected with or facilitating the national defense. Indemnification can be applied only to risks identified in the contract as being "unusually hazardous or nuclear in nature." Indemnification is given above the level of insurance maintained by the contractor, and the government has the right to require the contractor to maintain insurance (or a level of self-insurance). An exception to indemnification applies where willful misconduct or bad faith on the part of the contractor is the cause of the harm. Payments of indemnification are not limited by amounts of funds appropriated.

The indemnification authority provided by E.O. 10789, like the authority contained in 10 U.S.C. §2354, has serious limitations. *First,* indemnified contracts must be connected with the national defense. Many government projects with potential for catastrophic harm have, at most, only an indirect relation to national defense. *Second,* as with 10 U.S.C. §2354, indemnification under E.O. 10789 can only be provided where an "unusually hazardous" risk is involved, thereby eliminating from indemnification many types of risks which, though not "unusual," nevertheless have potential for causing catastrophic loss. *Third,* E.O. 10789 indemnification is discretionary. Unfortunately, agencies possessing indemnification authority under E.O. 10789 have given it very limited use. One agency, the National Aeronautics and Space Administration, until recently has refused to use the authority at all.[34] *Fourth,* the indemnification is not automatically extended to subcontractors.

Congress has also enacted a number of laws providing for indemnification in special circumstances. The best known of these is the Price-Anderson Act, enacted in 1957 in order to provide indemnification for contractors and licensees involved in the development of atomic energy.[35] Other special indemnification statutes have dealt with swine flu vaccination,[36] users of space vehicles,[37] rebuilding of the northeast rail corridor,[38] and prosthetic devices for veterans.[39] A wide variety of approaches to indemnification are reflected in these special statutes.

### C. *Voluntary Government Contractual Indemnification*

Aside from the contractual indemnification specifically authorized by the statutes enumerated above, various agencies of the government have at times voluntarily inserted indemnification clauses in some contracts. Section 7-203.22 of the Defense Acquisition Regulation specifies such a clause for use in military cost-reimbursement contracts. The clause provides for indemnification of contractors above the level of insurance without regard to any limitation of costs or funds otherwise contained in the contract. Exception is made for liability arising from the willful conduct or bad faith of the contractor. A corresponding clause for civilian agency cost-reimbursement contracts is found at §1-7.204-5 of the Federal Procurement Regulations (FPR).

On May 3, 1982, the Comptroller General issued a decision finding that the indemnification clause contained in FPR §1-7.204-5 violates the Anti-Deficiency Act,[40] and the Adequacy of Appropriations Act,[41] because it commits government funds for payment of liabilities which are undetermined at the time of contracting and which may have a cost in excess of available appropriations.[42] The decision effectively eliminates the usefulness of voluntary indemnification clauses as protection against catastrophic loss because the amount of liability in catastrophic situations will generally exceed the level of existing appropriations. Unless the decision is modified or reversed, contractors will now be able to obtain effective indemnification against catastrophic loss only in situations where indemnification statutes are applicable.[43]

### D. *Proposals for Expansion of Statutory Indemnification Authority*

Expansion of government indemnification has been proposed by a variety of groups over the last twenty years. In 1963, a study conducted by the Legislative Drafting Research Fund of Columbia University concluded that then-existing indemnification statutes were inadequate and should be augmented by a more comprehensive statute.[44] In 1968, a report of the Association of the Bar of the City of New York reached a similar conclusion.[45]

In the early 1970's, Congress established the Commission on Government Procurement to review the procurement process and make recommendations for changes. One recommendation in the Commission's final report was for comprehensive legislation to indemnify contractors against liability arising from catastrophes.[46] As a result of the Commission's recommendations, an interagency governmental task group was formed to study indemnification problems. In 1977, the task group drafted a bill which was circulated for comment by the Office of Federal Procurement Policy (OFPP). The bill provided for establishment of a more comprehensive indemnification scheme, but it was never submitted to Congress.[47] In 1978, OFPP drafted another bill and circulated it for comment, but no further action was taken.[48]

In 1981, another interagency task force was formed under the auspices of the OFPP. That task force completed a report, dated January 28, 1982, recommending that Executive Order 10789 be amended to expand the authority for contractual indemnification to all situations which could involve catastrophic loss, defined as liability above the level of available insurance.[49] This recommendation had not been implemented as of January 1, 1983.

In the 97th Congress a bill, H.R. 1504, was introduced which, although directed primarily at correcting the problem of government fault discussed above,[50] would also increase the availability of indemnification for catastrophic loss. It provides for indemnification of government contractors for all product liability arising from government contracts where the loss has not been occasioned by the "primary and active or willful negligence" of the contractor. Because the indemnification would be automatic, rather than on an optional contract-by-contract basis, this approach would make indemnification much more available than it is under 10 U.S.C. §2354 and E.O. 10789.

A task force of the National Association of Manufacturers submitted to the House Subcommittee considering H.R. 1504 proposed revisions which would provide for a more detailed approach to catastrophic loss indemnification.[51] Indemnification would be applied to all types of government contracts, whether for products or services. Indemnification would automatically apply whenever the level of liability of a government contractor reaches "unreasonable" proportions. Contracting agencies would by regulation establish levels at which contractor liability would be considered "unreasonable," taking into consideration such factors as the availability and cost of private insurance, the nature of the risk involved, and the size of the contractors involved. Indemnification would apply to both prime contractors and subcontractors, and payments would not be limited by the availability of appropriations. Indemnification would not be provided where the harm resulted from fraud, gross negligence, or willful misconduct of the contractor.

### E. *The Need for Resolution of the Catastrophic Loss Problem*

Several problems result from the existing patchwork system of government indemnification:

(1) The inconsistent availability of indemnification is unfair to those government contractors who are unable to obtain indemnification.

(2) When indemnification is not available, a strong deterrence to competition in the government procurement process is created. In some cases, this can prevent a vital program from going forward at all unless an additional indemnification statute is enacted.[52] In other cases, although not all companies are deterred from bidding for a contract, some are deterred, with the result that the government's procurement cost will be increased due to lack of price competition. In addition, since the most safety-conscious companies are those most likely to be deterred by lack of indemnification, the chances for a catastrophic event are increased as the government is forced to use less conscientious contractors.

(3) If a catastrophic event arises from a contract for which indemnification is not provided, the contractors involved will likely be bankrupted and the victims thereby left without remedy.[53]

In opposing a legislative solution to the foregoing problems, the Department of Justice has pointed primarily to the potentially large cost of providing broader indemnification.[54] There are several arguments, however, as to why cost should not be a basis for maintaining the status quo. *First,* the ultimate cost of indemnification may not be significantly greater, or even as great, as the cost of a less efficient, unplanned response to a catastrophe. *Second,* even if indemnification would involve additional cost, actual expenditures are likely to be infrequent and therefore of modest proportions on an annualized basis. *Third,* the indemnification cost will be offset at least partially by savings in procurement cost which would be attained through greater competition in bidding on high-risk projects.

## CONCLUSION

The tort liability problems of government contractors, both as to government fault and as to catastrophic loss, are a growing source of concern both for the government contracting community and for the public at large. Vital public policy considerations — promotion of safe practices by the government and the desirability of fairness and maximum industry participation in the procurement process — militate for legislative reform.

Because of the complex substantive and procedural considerations involved in the provision of government contribution and indemnification, fashioning workable solutions to the government fault and catastrophic loss problems is not an easy task. Nevertheless, the bills introduced or proposed to date provide a solid foundation for further action. Given the need for a legislative solution and the impetus for such a solution which has now developed, enactment of a comprehensive contribution and indemnification statute may soon become a reality.

## FOOTNOTES

[1] *In re "Agent Orange" Product Liability Litigation*, MDL 381 (E.D.N.Y.).

[2] 431 U.S. 666 (1977).

[3] *See* 28 U.S.C. §§ 2671 *et seq.* (1976).

[4] 340 U.S. 135 (1950).

[5] 431 U.S. at 672-74.

[6] *See, e.g., Thomas v. Lockheed Aircraft Corp.*, 665 F.2d 1330 (D.C. Cir. 1981); *Kudelka v. American Hoist & Derrick Co.*, 541 F.2d 651 (7th Cir. 1976); *Galimi v. Jetco, Inc.*, 514 F.2d 949 (2d Cir. 1975); *[illegible]velers Insurance Co. v. United States*, [illegible]3 F.2d 881 (3d Cir. 1974); *Newport Air Park, Inc. v. United States*, 419 F.2d 342 (1st Cir. 1969); *Murray v. United States*, 405 F.2d 1361 (D.C. Cir. 1968); *Wien Alaska Airlines, Inc. v. United States*, 375 F.2d 736 (9th Cir. 1967), *cert. denied*, 389 U.S. 940 (1967); *contra, Wallenius Bremen G.m.b.H. v. United States*, 409 F.2d 994 (4th Cir. 1969); *cert. denied*, 398 U.S. 958 (1970).

[7] Suits were also brought by orphans and military personnel, or their survivors.

[8] 665 F.2d at 1332-34.

[9] 50 U.S.L.W. 3797 (April 6, 1982).

[10] 406 U.S. 797 (1972).

[11] *In re "Agent Orange" Product Liability Litigation*, 534 F. Supp. 1046 (E.D.N.Y. 1982).

[12] 534 F. Supp. at 1053-58.

[13] Lee and Chierichella, "Government Specifications Defense for Product Liability Suits," *Contract Management* (May 1982).

[14] No. C80-924M (W.D. Wash., Sept. 15, [illegible]).

[15] *Id.*, slip op. at 9-10.

[16] *Id.*, slip op. at 5-8.

[17] *Id.*, slip op. at 7.

[18] *E.g., Challoner v. Day & Zimmerman, Inc.*, 512 F.2d 77 (5th Cir. 1975), *vacated on other grounds*, 423 U.S. 3 (1975); *Chapin v. Johns-Manville Sales Corp.*, No. S79-0272(N) (S.D. Miss., Nov. 2, 1981).

[19] S. Rep. No. 97-670, 97th Cong., 2d Sess. 13 (1982).

[20] H.R. 1504, 97th Cong., 1st Sess., § 4(a). *See also* H.R. 5351, 96th Cong., 1st Sess. (1979).

[21] Hearings Before the Subcommittee on Administrative Law and Governmental Relations of the Committee on the Judiciary, 97th Cong., 1st Sess. (1981).

[22] Letter from Ray Kline, Deputy Administrator, General Services Administration to Peter W. Rodino, Jr., Chairman, Committee on the Judiciary (Aug. 5, 1981); letter from Robert A. McConnell, Assistant Attorney General to Peter W. Rodino, Jr. (Aug. 7, 1981).

[23] Letter from T. Richard Brown, Chairman, NAM Task Force on Indemnification of Government Contractors, to Janet S. Potts, Assistant Counsel and James B. McMahon, Minority Counsel, Subcommittee on Administrative Law and Governmental Relations (March 15, 1982). Additional revisions were submitted by letters of May 20 and August 20, 1982.

[24] Statement of T. Richard Brown, submitted to the Senate Committee on the Judiciary Subcommittee on Agency Administration (Sept. 30, 1982) (Attachment).

[25] The unfairness of the *Stencel* doctrine, as well as its adverse effect on safety, has been recognized by a number of commentators. *E.g.*, Tobak, A Case of Mistaken Liability: The Government Contractor's Liability for Injuries Incurred by Members of the Armed Forces, 13 Publ. Cont. L.J. 74 (1982); Comment, Tort Remedies for Servicemen Injured by Military Equipment: A Case for Federal Common Law, 55 N.Y.U. L. Rev. 601 (1980); Graham, Products Liability and Tort Risk Distribution in Government Contract Programs, 1978 Air Force L. Rev. 331 (1978). In addition, judges have expressed frustration with the doctrine. *See, e.g., Henry v. Textron, Inc.*, 577 F.2d 1163 (4th Cir. 1978), *cert. denied*, 439 U.S. 1047 (1978); *see also Stencel Aero Engineering Corp. v. United States*, 431 U.S. at 674 (Marshall, J., dissenting).

[26] *See* 29 U.S.C. § 668 (1976) (specifying "responsibility" for heads of federal agencies to establish and maintain safety and health programs, but instituting no enforcement sanctions for such programs).

[27] Statement of J. Paul McGrath, Assistant Attorney General, submitted to the Senate Committee on the Judiciary Subcommittee on Agency Administration (Sept. 30, 1982).

[28] *Id.*

[29] The Department of Health and Human Services has been given authority to apply the indemnification plan specified in 10 U.S.C. § 2354 to research contracts of the Public Health Service. 42 U.S.C. § 241(a) (7) (Supp. IV 1980).

[30] 50 U.S.C. §§ 1431-35 (1976).

[31] S. Rep. No. 2281, 85th Cong., 2d Sess. (1958), *reprinted in* 1958 U.S. Code Cong. & Ad. News 4043, 4045.

[32] See 50 U.S.C. § 1431 (1976) (notes).

[33] Executive Order 10789, § 21. The civilian agencies are the Department of the Treasury, Department of the Interior, Department of Agriculture, Department of Commerce, Department of Transportation, Atomic Energy Commission, General Services Administration, National Aeronautics and Space Administration, Tennessee Valley Authority, Government Printing Office, and Federal Emergency Management Agency.

[34] *See* NASA Memorandum, 39 Fed. Cont. Rep. 216 (BNA) (1983).

[35] 42 U.S.C. § 2210 (1976).

[36] Pub. L. No. 94-380, 90 Stat. 1113 (1976).

[37] Pub. L. No. 96-48, 93 Stat. 345, § 308 (1979); 42 U.S.C. §2458b (Supp. IV 1980).

[38] Pub. L. No. 96-400, 94 Stat. 1687, § 101 (1980); 45 U.S.C. § 851 (Supp. IV 1980) (note).

[39] Pub. L. No. 85-857, 72 Stat, 1116 (1958).

[40] 31 U.S.C. § 665 (a) (1976).

[41] 41 U.S.C. § 11 (1976).

[42] Assumption by Government of Con-

tractor Liability to Third Persons, B-201072 (May 3, 1982).

[43] Both the Anti-Deficiency Act and the Adequacy of Appropriations Act contain an exception for expenditures "authorized by law."

[44] Legislative Drafting Research Fund of Columbia University, "Catastrophic Accidents in Government Programs" (1963), *reprinted in* "Government Procurement and Contracting (Part 8)," Hearings Before a Subcommittee of the Committee on Government Operations of the House of Representatives on H.R. 474, 91st Cong., 1st Sess. 2144-2331 (1969). The study was commissioned by the National Security Industrial Association.

[45] Association of the Bar of the City of New York, "Protection Against Catastrophic Accidents in Connection with Government Activities" (1968), *reprinted in* "Government Procurement and Contracting (Part 8)," Hearings Before a Subcommittee of the Committee on Government Operations of the House of Representatives on H.R. 474, 91st Cong., 1st Sess., 2332-36 (1969).

[46] Report of the Commission on Government Procurement 103-04 (1972).

[47] *See generally* letter from Robert D. Wallick, Chairman, Public Contract Law Section, American Bar Association to Donald E. Sowle, Administrator, Office of Federal Procurement Policy (Sept. 27, 1982) (attachment, at 3) (also submitted to the Senate Committee on the Judiciary Subcommittee on Agency Administration as an attachment to the statement of Robert D. Wallick, Dec. 2, 1982).

[48] *Id.* For a detailed historical review and analysis of proposals prior to 1981, *see* Stich, "Liability for Catastrophic Accidents Under Government Sponsored Activities: A Review, Analysis and Some Recommendations," *reprinted in* BNA Education Systems, "Briefing Conference on Government Contracts" (conference course book) (1980).

[49] Report of the OFPP Interagency Task Force on Indemnification, Part I, Indemnification of Government Contractors Against Third Party Liability Claims (Jan. 28, 1982).

[50] *See* section I.C.1. *supra.*

[51] *See* section I.C.2. *supra.*

[52] The National Swine Flu Immunization Program is an example. *See* Pub. L. No. 94-380, 90 Stat. 1113 (1976).

[53] If the event results from the government's negligence, victims can attempt to obtain recompense by suing under the Federal Tort Claims Act. They will generally face, however, a formidable task in attempting to overcome the "discretionary function" exception of the FTCA. *See Dalehite v. United States,* 346 U.S. 15 (1953).

[54] Statement of J. Paul McGrath, Assistant Attorney General, submitted to the Senate Committee on the Judiciary Subcommittee on Agency Administration (Sept. 30, 1982).

Senator GRASSELY. That concludes today's hearing. I am hopeful that out of all this material that has been gathered that we will be able to come forth with legislation to address this issue. I am also hopeful that we will get this record printed right away and distributed. Once again, I believe that we have formed a valuable record on which to base some decisions.

This hearing is adjourned.

[Whereupon, at 12 p.m., the subcommittee was adjourned.]

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